91-887

(1)

No. ________

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1991

SAMUEL KRUGLIAK and RICHARD L. PHILLIPS,
co-Disposition Assets Trustees for The
Mansfield Tire & Rubber Company, Debtor,
Petitioners,

v.

THE UNITED STATES OF AMERICA,
Respondent.

Petition for a Writ of Certiorari to the United
States Court of Appeals for the Sixth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

I. DOES CONGRESS' MERE CLASSIFICATION OF THE EXACTION IMPOSED BY SECTION 4971 OF THE INTERNAL REVENUE CODE UNDER THE HEADING OF "MISCELLANEOUS EXCISE TAXES" WITHDRAW FROM THE FEDERAL COURTS ANY AUTHORITY TO DETERMINE WHETHER A CLAIM FILED AGAINST A DEBTOR FOR PAYMENT PURSUANT TO THAT STATUTE QUALIFIES FOR DISTRIBUTIVE PRIORITY UNDER SECTION 507(a)(7)(E) OF THE BANKRUPTCY CODE?

II. ARE THE GOVERNMENT'S CLAIMS UNDER SECTION 4971 OF THE INTERNAL REVENUE CODE SUBJECT TO EQUITABLE SUBORDINATION UNDER SECTION 510(c)(1) OF THE BANKRUPTCY CODE AS NONPECUNIARY LOSS PENALTIES?

LIST OF PARTIES AND RULE 29.1 STATEMENT

The Petitioners and Respondent named above in the case caption were all of the parties before the United States Court of Appeals for the Sixth Circuit in the case below. The Petitioners are co-Disposition Assets Trustees for the Debtors, The Mansfield Tire & Rubber Company, the Pennsylvania Tire and Rubber Company of Mississippi, Inc. and the Pennsylvania Tire Company, Inc., in this substantively consolidated bankruptcy case. The Mansfield Tire & Rubber Company was named as a Defendant in the court below but not as an Appellee. No parent or subsidiary company is required to be listed under Supreme Court Rule 29.1.

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IN THE

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Respondent.

**PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT**

Samuel Krugliak and Richard Phillips, co-Disposition Assets Trustees for the Mansfield Tire & Rubber Company, Debtor, request that this Court issue a writ of certiorari to the United States Court of Appeals for the Sixth Circuit to review that court's final judgment filed on August 28, 1991.

OPINIONS BELOW

The United States Court of Appeals for the Sixth Circuit's opinion below is officially reported at 942 F.2d 1055 (6th Cir. 1991). A-1.[1] In that opinion, the sixth circuit reversed an order of the United States District Court for the Northern District of Ohio, which is reported at 120 Bankr. 862 (N.D.Ohio 1990). A-19. The district court's order had affirmed a decision and order rendered by the United States Bankruptcy Court for the Northern District of Ohio, which is reported at 80 Bankr. 395 (Bankr. N.D. Ohio 1987). A-36.

JURISDICTIONAL STATEMENT

The decision of the United States Court of Appeals for the Sixth Circuit in this case was decided and filed on August 28, 1991. Upon motion of Petitioners herein, the sixth circuit stayed the issuance of its mandate on September 26, 1991. This Court has jurisdiction to review the final judgment of the court of appeals by writ of certiorari pursuant to Section 1254(1) of Title 28, United States Code. 28 U.S.C. § 1254(1).

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[1] The Appendix to this Petition is cited as "A-__."

STATUTORY PROVISIONS AT ISSUE

This case principally requires interpretation and application of Sections 507(a)(7)(E)[2] and 510(c)(1) of the Bankruptcy Code, 11 U.S.C. §§ 507(a)(7)(E) & 510(c)(1), and Section 4971 of the Internal Revenue Code, 26 U.S.C. § 4971. These statutory provisions are reprinted in pertinent part in the Appendix. A-57.

STATEMENT OF THE CASE

In October and November of 1979, The Mansfield Tire & Rubber Company and two related corporations, the Pennsylvania Tire and Rubber Company of Mississippi, Inc. and the Pennsylvania Tire Company, Inc. (collectively referred to herein as "Mansfield" or the "Debtors"), filed petitions in the Bankruptcy Court for the Northern District of Ohio seeking relief under Chapter 11 of the Bankruptcy Code, 11 U.S.C. § 101 et seq. On December 30, 1985, following complete cessation of the Debtors' business operations and, therewith, any possibility of enterprise rehabilitation, the Bankruptcy Court confirmed a consolidated plan of reorganization under which the Debtors' assets were vested in a Disposition Assets Trust for purposes of liquidation and distribution of the proceeds. The Petitioners herein, Samuel Krugliak and Richard L. Phillips, are the duly appointed and acting

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[2] The priority section originally applicable to this dispute was Section 507(a)(6) of the Bankruptcy Code. Section 507(a)(6) was redesignated as Section 507(a)(7) by Congress in 1984. *See* Bankruptcy Amendments and Federal Judgeship Act of 1984, §§ 350 & 553, Pub. L. No. 98-353, 98 Stat. 333, 358, 392. For ease of reference, this Petition will cite to the currently applicable provisions of Section 507(a)(7).

co-Disposition Assets Trustees for the consolidated Debtors (the "Trustees").

During its tax years ending December 31, 1977 through 1979, Mansfield maintained a qualified pension plan under Section 401 of the Internal Revenue Code, 26 U.S.C. § 401. For those years, Mansfield failed to fund the pension plan in accordance with the requirements of Section 412 of the Internal Revenue Code, 26 U.S.C. § 412. In December 1979, Mansfield filed appropriate tax returns for its 1977 and 1978 tax years, reporting liabilities of $101,380 and $213,828 respectively under Internal Revenue Code Section 4971(a), 26 U.S.C. § 4971(a), for failure to meet minimum funding requirements applicable to the pension plan. Payment of the liability did not accompany the returns. In 1980 and 1981, the Internal Revenue Service ("IRS") filed a proof of claim and subsequent amendments thereto against Mansfield, asserting a priority claim totalling $363,111.20 for the liabilities under Section 4971(a) reported on the returns.

On October 18, 1986, the Trustees filed an objection to the IRS' proof of claim contesting the IRS' contention that the liabilities due under Section 4971(a) should receive priority treatment under Section 507(a)(7)(E) of the Bankruptcy Code, 11 U.S.C. § 507(a)(7)(E). The bankruptcy court originally had jurisdiction over this dispute under 28 U.S.C. § 1334(a) and 28 U.S.C. § 157. On the Trustees' motion for summary judgment, the bankruptcy court held in a thorough and thoughtful opinion (i) that, for bankruptcy purposes, the purported "tax" imposed by Section 4971 was a penalty which was not entitled to priority, and (ii) that the Section 4971 claim would be equitably subordinated to the claims of general unsecured creditors pursuant to Section 510(c) of the Bankruptcy Code. In reaching these

conclusions, the bankruptcy court relied on Congress' clear intention, as expressed in the legislative history, that the exaction under Section 4971 is a penalty levied against employers for violating the statutory minimum funding requirements. The United States appealed the bankruptcy court's judgment to the United States District Court for the Northern District of Ohio. The district court, in yet another extensive and well considered opinion, affirmed the decision of the bankruptcy court in all respects.

The United States then appealed the district court's judgment to the United States Court of Appeals for the Sixth Circuit. On August 28, 1991, the sixth circuit reversed the district court's judgment, holding that the taxes imposed by Section 4971 of the Internal Revenue Code are "excise taxes" entitled to distributive priority under Section 507(a)(7)(E) of the Bankruptcy Code. In reaching this conclusion, the sixth circuit relied on its understanding of the plain meaning of the words "excise tax on . . . a transaction . . ." in Section 507(a)(7)(E) and on the location of Section 4971 in Subtitle D of the Internal Revenue Code, which is entitled "Miscellaneous Excise Taxes." Upon application of the Trustees, the court of appeals stayed the issuance of its mandate permitting the Trustees to present this Petition.

ARGUMENT

I. THE COURT OF APPEALS' HOLDING IS FUNDAMENTALLY INCONSISTENT WITH THIS COURT'S PRIOR DECISIONS AND IS IN CONFLICT WITH DECISIONS OF THE COURTS OF APPEALS REGARDING THE CHARACTERIZATION AND TREATMENT OF GOVERNMENTAL EXACTIONS FOR PURPOSES OF BANKRUPTCY LAW.

This Court has long held that the mere name given to a governmental exaction by the legislature is not conclusive in determining whether the exaction will be deemed a tax for purposes of federal bankruptcy law. *See, e.g., United States v. Sotelo,* 436 U.S. 268 (1978); *City of New York v. Feiring,* 313 U.S. 283 (1941); *New Jersey v. Anderson,* 203 U.S. 483 (1906). Rather than rely on statutory labels, the Court has regarded the character and purpose of the exaction in question as the dispositive considerations in the treatment of a governmental claim in bankruptcy proceedings. *See Sotelo,* 436 U.S. at 275; *Feiring,* 313 U.S. at 287. Prior to the decision of the court of appeals in this case, lower courts had uniformly applied this rule of statutory interpretation when resolving whether a governmental claim against a debtor would be treated as a tax liability in the context of bankruptcy proceedings. *See, e.g., United States v. River Coal Co.,* 748 F.2d 1103 (6th Cir. 1984); *In re Lorber Industries of California, Inc.,* 675 F.2d 1062 (9th Cir. 1982); *In re Unified Control Systems, Inc.,* 586 F.2d 1036 (5th Cir. 1978); *In re Kline,* 403 F. Supp. 974 (D. Md. 1975), *aff'd,* 547 F.2d 823 (4th Cir. 1977).

The decision below represents a radical departure from this precedent, baldly pronouncing that the federal

courts lack the authority to inquire behind the labels used by Congress in the Internal Revenue Code to decide whether a claim for a federal "tax" liability is entitled to distributive priority under the Bankruptcy Code. According to the court of appeals, no basis lies for independent judicial interpretation of federal revenue statutes in such instances. From the appellate court's perspective, the sole consideration is the label employed by Congress: if an exaction is merely labeled a "tax" in the Internal Revenue Code, then it must be conclusively deemed a "tax" for purposes of bankruptcy law, and critical judicial review is absolutely prohibited.

The implications of the court of appeals' decision thus extend far beyond the specific issue of whether governmental claims for amounts owed pursuant to Section 4971 are to be granted distributive priority under Section 507(a)(7)(E). The appellate court's decision alters the basic principles used by this Court and the lower federal courts to decide cases raising the interaction of federal tax provisions and bankruptcy law.

A. The court of appeals erred when it failed to recognize and apply this Court's holding in *Sotelo* that the statutory designation of an exaction in the Internal Revenue Code is not dispositive of the exaction's treatment as a claim in bankruptcy.

In *United States v. Sotelo,* 436 U.S. 268, 275 (1978), this Court held that, despite Congress' express designation of the exaction provided in Internal Revenue Code Section 6672 as a "penalty," the exaction's "essential character" requires its treatment as a "tax" for purposes of the Bankruptcy Act. Conversely, the instant case presents a federal revenue statute, Section 4971, that refers to the assessment as a "tax" and is included in a subtitle of the

Internal Revenue Code entitled "Miscellaneous Excise Taxes," but which the district and bankruptcy courts determined to possess the essential characteristics of a penalty. The instant case was thus presented to the court of appeals as the converse of *Sotelo*.[3]

The court of appeals, in reversing the district court's decision, did not simply reject the lower courts' determination that the Section 4971 exaction bears the essential characteristics of a penalty. It held that the federal courts are utterly powerless to make such a finding in light of Congress' designation of the exaction as a "tax." This ruling is manifestly at odds with the Court's decision in *Sotelo*. If, as the appellate court determined, the statutory label for an exaction in the Internal Revenue Code is dispositive of its treatment in bankruptcy, then the viability of the holding in *Sotelo* is necessarily in doubt.

In *Sotelo*, the respondent debtor was found personally liable to the federal government for his failure to pay over taxes withheld from employees of the corporation in which respondent was the principal officer. This liability was predicated on Internal Revenue Code Section 6672, providing, in relevant part, that a person required to collect and pay over any tax who willfully fails to do so "shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax . . . not accounted for and paid over." 26 U.S.C. § 6672. Sotelo sought to obtain discharge of this liability in bankruptcy, arguing that the plain language of Section 6672 directed treatment of the exaction as a penalty

[3] Petitioners presented *Sotelo* as controlling precedent in their arguments to the sixth circuit panel. Nevertheless, the appellate court failed even to mention, let alone attempt to distinguish, this Court's decision in its opinion.

dischargeable under the Bankruptcy Act. The United States Court of Appeals for the Seventh Circuit found this argument persuasive, holding that the "penalty" language of Section 6672 was conclusive in determining the nature of Sotelo's liability. *In re Sotelo,* 551 F.2d 1090, 1092 (7th Cir. 1977).

This Court reversed, holding that the liability was, in fact, for a tax that was not dischargeable under Section 17a(1)(e) of the Bankruptcy Act. 11 U.S.C. § 35(a) (1976). According to the *Sotelo* Court, this result was dictated both by the terms of the Bankruptcy Act and by the nature of the exaction in question. The Court addressed specifically the Seventh Circuit's view that Congress' designation of the Section 6672 assessment as a penalty was controlling:

> We also cannot agree with the Court of Appeals that the "penalty" language of Internal Revenue Code § 6672 is dispositive of the status of respondent's debt under Bankruptcy Act § 17a(1)(e). . . . That the funds due are referred to as a "penalty" when the Government later seeks to recover them does not alter their essential character as taxes for purposes of the Bankruptcy Act, at least in a case in which, as here, the liability is predicated on a failure to pay over, rather than a failure initially to collect, taxes.

Sotelo, 436 U.S. at 275. The principle articulated by the *Sotelo* Court is clear: in interpreting a federal exaction statute in the bankruptcy context, a court must look beyond Congress' denomination of the exaction if the

legislative label is unwarranted by the exaction's "essential character."

The conflict between the court of appeals' decision in the instant case and this Court's holding in *Sotelo* can be best illustrated by applying the appellate court's approach to statutory interpretation to the Section 6672 exaction. The court of appeals' decision on the facts presented in *Sotelo* would appear to be along the lines of the following analysis -- Congress has expressly treated the Section 6672 exaction as a "penalty." It is referred to as a "penalty" in the language of the section itself and is contained within Subchapter B, entitled "Assessable Penalties," of Chapter 68, Subtitle F of the Internal Revenue Code. The court is unaware of any intent by Congress to have its characterizations of payments as "penalties" subject to second-guessing by the federal courts and therefore will not independently decide whether Congress meant "penalty" when it said "penalty" -- which is utterly contradictory of *Sotelo.*

In short, application of the court of appeals' reasoning to the issue in *Sotelo* would result in a complete reversal of the Court's substantive holding in that case, requiring that Section 6672 liabilities be treated as dischargeable tax penalties under current bankruptcy law. 11 U.S.C. § 523(a)(7). *Cf. Garrett v. Internal Revenue Service (In re Garrett),* 126 Bankr. 486 (Bankr.E.D.Va. 1991) (following *Sotelo* in interpretation of Section 6672 liabilities under Bankruptcy Code); *Matlock v. United States (In re Matlock),* 104 Bankr. 389 (Bankr.N.D.Okla. 1989) (same).

The failure of the court of appeals to honor and apply the holding of *Sotelo* in the instant case is inexplicable. Nothing in the language of the Internal

Revenue Code provisions at issue in the two cases suggests that the legislative denomination of the Section 4971 assessment as a "tax" should be afforded any greater deference than Congress' designation of the Section 6672 exaction as a "penalty." Indeed, the court of appeals' ultimate conclusion that the Section 4971 exaction must be treated as an "excise tax" for bankruptcy priority purposes is even less defensible than the "penalty" argument at issue in *Sotelo* since the "excise tax" label is taken not from the language of Section 4971, but from the caption to Subtitle D of the Internal Revenue Code, under which Section 4971 is located.

Nor does the fact that *Sotelo* resolved the issue of dischargeability of a liability under the Bankruptcy Act, rather than the question of distributive priority of a governmental claim under the Bankruptcy Code, somehow make *Sotelo* inapposite. The dispositive question in both cases is the ability of the courts to look behind a federal exaction's statutory label in determining its treatment for purposes of bankruptcy law. The holding of the *Sotelo* Court on this point applies regardless of the bankruptcy provision at issue.

The decision below cannot be reconciled with this Court's ruling in *Sotelo*. No intervening decision of this Court suggests that the fundamental principle of statutory construction articulated in that case has been discarded or modified. The Court is therefore presented with the question whether *Sotelo* continues to serve as controlling precedent with respect to the construction of federal revenue statutes in bankruptcy proceedings. The Court should recognize the inherent conflict between its precedent and the appellate court's holding and, upon review, reaffirm the rule set forth in *Sotelo*.

B. The court of appeals fundamentally erred when it relied exclusively on a subtitle caption in the Internal Revenue Code and failed to apply the interpretive standard established by this Court in *Sotelo* and *Feiring* to determine whether the Section 4971 exaction is an "excise tax" for purposes of Section 507(a)(7)(E).

1. The court of appeals erred in relying exclusively on the classification scheme of the Internal Revenue Code to find the "plain meaning" of Section 507(a)(7)(E) of the Bankruptcy Code.

As this Court recently stated in a case decided under the Bankruptcy Code, statutory interpretation "must begin . . . with the language of the statute itself." *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 241 (1989). "[W]here the language of the Bankruptcy Code is plain, 'the sole function of the courts is to enforce it according to its terms.'" *Id.* (quoting *Caminetti v. United States*, 242 U.S. 470, 485 (1917)). Seizing on this language from *Ron Pair*, the court of appeals purported to apply a "plain meaning" analysis and summarily concluded that a claim under Section 4971 of the Internal Revenue Code is an "excise tax on . . . a transaction" under Section 507(a)(7)(E). The court of appeals' analysis is both enlightening and disturbing.[4]

[4] The court of appeals' version of "plain meaning" analysis in this case brings to mind Justice Frankfurter's oft-quoted admonition: "The notion that because the words of a statute are plain, its meaning is also plain, is merely pernicious oversimplification." *United States v. Monia*, 317 U.S. 424, 431 (1943) (Frankfurter, J., dissenting).

The court of appeals observed correctly that the Bankruptcy Code does not define the terms "tax" and "excise tax." In an amazing feat of statutory construction, the court filled this void by concluding that the "plain meaning" of Section 507(a)(7)(E) could be found not in the terms or purposes of the Bankruptcy Code, but in the classification scheme of the Internal Revenue Code.[5]

At the heart of the appellate court's decision is its finding that Congress has expressly deemed the assessment provided in Section 4971(a) to be an "excise tax." The court made this finding based not on the language of the statute itself, but solely on the fact that Section 4971 is located within Subtitle D of the Internal Revenue Code. That subtitle is denominated "Miscellaneous Excise Taxes" in the Internal Revenue Code's table of contents. The court relied on the subtitle's caption to conclude that Congress meant to include the exactions contained in Subtitle D within the scope of the excise taxes subject to distributive priority under Section 507(a)(7)(E). The appellate court's decision thus rests entirely on its determination that Congress' placement of Section 4971 in Subtitle D represents a clear expression of legislative intent to treat the exaction provided in that section as an excise tax for all purposes.

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[5] Comparing Section 507(a)(7)(E) to the statute at issue in *Ron Pair*, the court of appeals initially commented that "the statutory language held to have plain meaning in *Ron Pair* -- a lengthy phrase in Bankruptcy Code § 506(b) containing several clauses -- is undoubtedly less plain than the language we are presented with here, the term 'excise tax'." By this implicit *a fortiori* argument, the court apparently reduced the "plain meaning" analysis to one of counting words and phrases. The error in such an approach seems patent and will not be addressed further.

This conclusion cannot be defended. The location of Section 4971 in Subtitle D and the descriptive title given to that subtitle are simply immaterial in determining legislative treatment of the Section 4971 exaction for any purpose. Congress has explicitly stated that

> [n]o inference, implication, or presumption of legislative construction shall be drawn or made by reason of the *location or grouping* of any particular section or provision or portion of [Title 26] . . . , nor shall any table of contents, table of cross references, or similar outline, analysis, or *descriptive matter* relating to the contents of [Title 26] . . . be given any legal effect.

26 U.S.C. § 7806(b) (emphasis added). By enacting this provision, Congress sought to prohibit the very process by which the court of appeals determined that the Section 4971 exaction is an excise tax. By relying on the location of Section 4971 and descriptive heading of Subtitle D, the court of appeals plainly employed an impermissible approach to statutory construction to reach its conclusion.

Once this finding is discarded, the intellectual poverty of the "label matching" methodology propounded by the appellate court becomes clear. Stripped of its sole rationale, the court of appeals' interpretation of the statute is without substance; it provides no legitimate reason to conclude that the government's Section 4971 claims must be treated as "excise tax" claims under Section 507(a)(7)(E), and it provides absolutely no guidance to courts considering the same or similar issues in the future. To the extent the "plain meaning" of Section 507(a)(7)(E) is discernible, it is never explained, leaving no basis for

determining whether, in fact, the Section 4971 exaction is entitled to priority.[6]

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[6] Two additional flaws in the court of appeals' "plain meaning" analysis must be noted. First, the Trustees had argued that the statutory language "excise tax on . . . a transaction" in Section 507(a)(7)(E) must be considered in its entirety and applied to this case, and that the failure to fund a pension plan is not a "transaction" within the statute's meaning. The court, however, dismissed this argument in a footnote, cryptically stating that "[w]e find no merit in this argument." A-10 n. 4. Thus, while purporting to apply the statute's plain meaning to the case, the court was nonetheless unable to articulate how the statutory term "transaction" applies to the exaction under Section 4971. This void in the court's analysis again accentuates the analytical weakness in the court's decision.

Second, the appellate court explicitly approved an analytical framework that provided differing treatment for state and local taxes as opposed to federal exactions. A-10. No language in the statute or its legislative history was cited for this conclusion. The statute itself simply refers to "excise taxes" without further differentiation. The court of appeals therefore considered matters outside of the plain meaning of the statute to reach this dichotomous treatment of federal and state exactions. It is quite ironic that the result of the court of appeals' "plain meaning" inquiry, as the court acknowledges, is a two-tiered analysis that is not required or supported by the statutory language.

Also contrary to the two-tiered analysis espoused by the court, the applicable legislative history treats all exactions on par: "All Federal, State and local taxes generally considered or expressly treated as excise taxes are covered by this category . . .." 124 Cong. Rec. H 11089 (September 28, 1978) (Statement by Rep. Edwards) (emphasis added), *reprinted in* 1978 U.S. Code Cong. & Admin. News 6436, 6498; 124 Cong. Rec. S 17406 (October 6, 1978) (Statement by Sen. DeConcini), *reprinted in* 1978 U.S. Code Cong. & Admin. News 6505, 6567. The court was able to ignore the ramifications of this aspect of the legislative history by using an ellipsis to delete the references to "State and local" taxes in its use of the quotation. A-8 n.3. Such judicial sleight-of-hand should not be countenanced as an approach to discovering the meaning of a federal statute.

2. The court of appeals should have applied the framework of statutory interpretation found in *Sotelo* and *Feiring*.

The appropriate framework to be used by the courts in assessing the priority treatment of federal exactions is provided in this Court's decisions in *Sotelo* and *City of New York v. Feiring*, 313 U.S. 283 (1941). As discussed above, *Sotelo* mandates that in applying the bankruptcy laws to a federal exaction, the federal courts must assess the "essential character" of the exaction to determine whether the exaction's label will be respected for bankruptcy purposes. This Court's decision in *Feiring* provides an example of such an analysis in the context of determining the distributive priority of a "tax" under the bankruptcy laws and should have guided the court of appeals' analysis in this case.

This Court held in *Feiring* that it is the "terms and purposes" of federal bankruptcy law which establish the criteria for determining whether a governmental exaction is entitled to distributive priority. *Id.* at 285. Accordingly, a court considering an alleged priority claim must determine whether the "incidents" of the governmental assessment are such as to constitute the type of exaction that is contemplated by the priority statute. *Id.* Application of this principle in the instant case dictates a two-step process of judicial inquiry and interpretation. First, the characteristics of those exactions entitled to priority under Section 507(a)(7)(E) must be defined in light of the section's "terms and purposes." Second, the court must determine whether the Section 4971 exaction possesses those characteristics.

The court of appeals expressly rejected application of the *Feiring* analysis, asserting that the analytic precepts

articulated by the Court in that case apply only in those instances when at issue are priority claims for state or local exactions. While the assessment at issue in *Feiring* was enacted by a state government, no court prior to the court of appeals' decision below had so limited the decision's analytical approach. Indeed, this Court has itself relied on *Feiring* in its consideration of the priority treatment of a federal tax claim under the Bankruptcy Act. *See United States v. State of New York*, 315 U.S. 510, 515 (1942).[7]

Moreover, the court of appeals failed to appreciate that even if *Feiring* is not technically controlling, its analysis is persuasive authority in determining how to fill the void left in the Bankruptcy Code's failure to define the term "excise tax". The process, as set out in *Feiring*, of defining the essential characteristics of an "excise tax" within the meaning of Section 507(a)(7)(E) based on that statute's terms and purposes, and then assessing the statute underlying the asserted priority claim, Section 4971, in light of those characteristics, is not an improper judicial enterprise, as the court of appeals held, but a legitimate exercise of the court's responsibility to determine the meaning of a federal statute. While reasonable minds might differ on how to define the characteristics of an "excise tax" under Section 507(a)(7)(E) and on whether the "incidents" of the exaction provided in Section 4971 reflect those

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[7] In *United States v. State of New York*, the Court was faced with a claim for an unpaid federal Social Security Tax that was assessed against the employee but collectable from the employer. In upholding the United States' contention that the claim merited priority treatment under Bankruptcy Act in the employer's bankruptcy proceeding, this Court conclude that "our decision in the Feiring case is controlling here." 315 U.S. at 515.

characteristics, these are inquiries that the federal courts must make under the Bankruptcy Code if its terms and purposes are to be given effect.

By inferring legislative intent from facts which Congress has declared irrelevant to the interpretation of its enactments, the court of appeals abdicated its responsibility to engage in judicial inquiry and interpretation in determining whether the exaction provided in Section 4971 actually constitutes an excise tax for purposes of Section 507(a)(7)(E). That the court had such a responsibility is beyond question. There is no basis for treatment of the Section 4971 exaction as an excise tax for purposes of distributive priority absent judicial definition of the characteristics of such taxes and determination by the court that the exaction possesses those characteristics. In short, the court was required to engage in the interpretive process articulated by this Court in *Sotelo* and *Feiring*. The failure of the court of appeals to engage in such a process -- indeed, its outright rejection of any judicial role in the statutory interpretation -- requires review and correction by this Court.

C. This Court should resolve the conflict among the courts of appeals regarding the interpretation and treatment of federal exactions for purposes of bankruptcy law.

The court of appeals recognized that its decision in the instant case was in conflict with the decision of the United States Court of Appeals for the Fourth Circuit in *In re Kline,* 547 F.2d 823 (4th Cir. 1977), *aff'g,* 403 F. Supp. 974 (D. Md. 1975), and that of the United States Court of Appeals for the Fifth Circuit in *In re Unified Control Systems, Inc.,* 586 F.2d 1036 (5th Cir. 1978). In each of those decisions, the court held that the

exaction provided in Internal Revenue Code Section 4941, 26 U.S.C. § 4941, although labeled a "tax" in statute, is a penalty for bankruptcy purposes and should be treated as such in determining whether a claim for liability under the statute was disallowed under the Bankruptcy Act. *Unified Control*, 586 F.2d at 1039; *Kline*, 403 F. Supp. at 978.

The exactions provided in Section 4971 and Section 4941 are both contained in Subtitle D of the Internal Revenue Code; both are labeled a "tax" in the statute's text. Yet in both instances, the nature of the assessment and the legislative history of the statute demonstrate that the exaction is intended to deter undesirable conduct by imposing a penalty, not to obtain revenue for governmental purposes or to compensate the government for revenues lost as a result of the sanctioned conduct.[8] The common question among the cases is whether the exaction's putative name and classification or its nature and purpose are the dispositive considerations in determining the exaction's entitlement to distributive priority in bankruptcy proceedings.

Rather than attempt to distinguish *Kline* and *Unified Control*, the sixth circuit panel stated that, in its view, those cases were wrongly decided to the extent that they held that the federal courts should look beyond Congress' classification of an exaction to determine whether the exaction was a "tax" for bankruptcy law purposes. The "label matching" approach adopted by the sixth circuit panel cannot be reconciled with the interpretive analysis endorsed by the *Kline* and *Unified*

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[8] See *Kline*, 403 F. Supp. at 977-78, for an analysis of the Section 4941 exaction; see the orders of the district court, A-21 & A-25 to A-26, and the bankruptcy court, A-40 to A-48, for discussions of the Section 4971 exaction.

Control courts. An acknowledged actual conflict therefore exists between the decision of the sixth circuit in the instant case and the appellate decisions in *Unified Control* and *Kline*, presenting sufficient grounds for review by this Court. This Court should resolve this conflict and return certainty to this critical question of bankruptcy law in the federal courts.

II. THE COURT OF APPEALS ERRONEOUSLY CONCLUDED THAT THE GOVERNMENT'S SECTION 4971 CLAIMS WERE NOT SUBJECT TO EQUITABLE SUBORDINATION AS NONPECUNIARY LOSS PENALTIES UNDER SECTION 510(c)(1) OF THE BANKRUPTCY CODE.

The court of appeals held that the government's claims pursuant to Section 4971 of the Internal Revenue Code are not subject to equitable subordination under Section 510(c)(1) of the Bankruptcy Code, contrary to the conclusions of both the bankruptcy and district courts. The court's decision was premised, however, on its erroneous conclusion that the government's Section 4971 claims were entitled to distributive priority under Section 507(a)(7)(E) of the Bankruptcy Code. As demonstrated more fully above, the sixth circuit's conclusion as to the priority status of Section 4971 claims is fraught with error. Because the court of appeals' equitable subordination analysis flowed directly from its holding on the priority question, the equitable subordination analysis is similarly flawed and should be reviewed by this Court.[9]

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[9] Given that the sixth circuit's decision on the equitable subordination question was based entirely on the court's view of the priority status of the government's Section 4971 claims, a reversal by

The Trustees note, however, that the key question presented by this Petition is the appellate court's treatment of the government's Section 4971 claims. If the court of appeals' decision regarding the priority status of the Section 4971 claims were to be affirmed by this Court, the Trustees would not assert that equitable subordination of those claims would still be warranted. On the other hand, once the government's claims under Section 4971 are rightly seen as the penalties that Congress clearly intended them to be, the propriety of the district court's and bankruptcy court's decisions to equitably subordinate those claims becomes clear.[10]

A. The bankruptcy courts' power to equitably subordinate claims derives from their fundamental nature as courts of equity.

The ultimate foundation for the lower courts' decisions to subordinate Section 4971 penalty claims is the bankruptcy court's traditional status as a court of equity. *See Young v. Higbee Co.*, 324 U.S. 204, 214 (1945) ("Courts of bankruptcy are courts of equity and exercise all equitable powers unless prohibited by the Bankruptcy

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this Court on the priority issue might justify a remand to the court of appeals to reconsider in the first instance the equitable subordination question under the appropriate legal standard.

[10] The penalty imposed by Section 4971 would clearly not be entitled to priority under Section 507(a)(7)(G) of the Bankruptcy Code, which grants priority to a tax penalty if it is "a penalty related to a claim of a kind specified in this paragraph and is compensation for actual pecuniary loss." 11 U.S.C. § 507(a)(7)(G). The penalty imposed by Section 4971 is neither "related to a claim of a kind specified in [Section 507(a)(7)]," nor is it "in compensation for actual pecuniary loss." Once the Section 4971 claim is deemed a penalty, therefore, it will not be entitled to any priority treatment under the Bankruptcy Code.

Act"). In exercising its equitable powers, the bankruptcy court is charged with primary responsibility "to bring about an equitable distribution of the bankrupt's estate among creditors holding just demands based upon adequate consideration." *Kothe v. R.C. Taylor Trust*, 280 U.S. 224, 227 (1930); *see also Simonson v. Granquist*, 369 U.S. 38, 40 (1962) (". . . broad aim of the [Bankruptcy] Act [is] to provide for the conservation of the estates of insolvents to the end that there may be as equitable a distribution of assets as is consistent with the type of claims involved."). "[H]istorically one of the prime purposes of the bankruptcy law has been to bring about a ratable distribution among creditors of a bankrupt's assets; *to protect the creditors from one another.*" *Higbee*, 324 U.S. at 210 (emphasis added).

The pursuit of an equitable distribution of the debtor's estate, coupled with the traditional aversion of the bankruptcy law to the enforcement of nonpecuniary loss penalty claims at the expense of the debtor's innocent creditors, *see Simonson*, 369 U.S. at 40-41 (discussing § 57j of the Bankruptcy Act, which barred all governmental nonpecuniary loss penalties), has led the courts to invoke their equitable jurisdiction to protect creditors suffering pecuniary loss from those whose claims are punitive in nature, *see Schultz Broadway Inn v. United States*, 912 F.2d 230, 234 (8th Cir. 1990) (Bankruptcy Code "generally prefers claims for actual losses over purely punitive claims").

B. Equitable subordination under Section 510(c)(1) is not dependent on inequitable conduct by the creditor, but may be premised on the punitive nature of a claim, including the government's penalty claims under Section 4971.

Congress explicitly preserved the bankruptcy court's equity jurisdiction in the distribution context in Bankruptcy Code Section 510(c)(1), which provides in relevant part that "the court may . . . under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim . . .." 11 U.S.C. § 510(c)(1). The phrase "principles of equitable subordination" is not defined in the Code, but the legislative history reveals the following:

> It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts the development of this principle. To date, *under existing law*, a claim is generally subordinated only if the holder of such claim is guilty of inequitable conduct, *or the claim itself is of a status susceptible to subordination, such as a penalty* . . ..

124 Cong. Rec. H 11089 (September 28, 1978) (Statement by the Hon. Don Edwards), *reprinted in* 1978 U.S. Code Cong. & Admin. News 6436, 6452 (emphasis added); 124 Cong. Rec. S 17406 (October 6, 1978) (Statement by the Hon. Dennis DeConcini), *reprinted in* 1978 U.S. Code Cong. & Admin. News 6505, 6521.

In enacting Section 510(c)(1), therefore, Congress specifically contemplated that penalty claims would be subject to equitable subordination even in the absence of

inequitable conduct. Accordingly, the courts which have considered the question have uniformly concluded that nonpecuniary loss penalty claims are subject to equitable subordination solely because they are penalties and without regard to creditor misconduct. *See, e.g., In re Burden*, 917 F.2d 115 (3d Cir. 1990) (federal tax penalties subordinated); *Schultz Broadway Inn*, *supra* (federal tax penalties subordinated); *Matter of Virtual Network Services Corporation*, 902 F.2d 1246 (7th Cir. 1990) (federal tax penalties subordinated); *In re Merwede*, 84 Bankr. 11 (Bankr. D. Conn. 1988) (federal tax penalties subordinated); *In re Quality Sign Co., Inc.*, 51 Bankr. 351 (Bankr. S.D. Ind. 1985) (federal tax penalties subordinated); *In re Colin*, 44 Bankr. 806 (Bankr. S.D. N.Y. 1984) (punitive damages claim subordinated).[11]

Moreover, the fact that the government's claim in this case bears the label of a "tax" is irrelevant to the analysis. Congress has never evinced an intention to permit subordination of "tax" claims only upon a finding of misconduct by the taxing authority. In fact, Congress explicitly refused to create a special subordination rule for

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[11] Several bankruptcy courts have treated tax penalty claims on par with the claims of general unsecured creditors, but in each case the court has done so without discussing the issue of equitable subordination. *See In re Patco Photo Corp.*, 82 Bankr. 192 (Bankr. E.D. N.Y. 1988); *In re Falwell Excavating Co., Inc.*, 40 Bankr. 315 (Bankr. W.D. Va. 1984) (court did not address trustee's equitable subordination argument); *In re Coleman American Companies, Inc.*, 26 Bankr. 825 (Bankr. D. Kansas 1983); *In re Hernando Appliances, Inc.*, 41 Bankr. 24 (Bankr. N.D. Miss. 1983); *In re Program Management and Design Associates, Inc.*, 25 Bankr. 144 (Bankr. D. Mass. 1982).

tax claims under Section 510(c)(1). The Senate Report to an earlier version of the Code explicitly notes:

> As originally introduced, the bill provided specifically that a tax claim may not be subordinated on equitable grounds. The bill deletes this express exception, but the effect under the amendment should be much the same in most situations since, under the judicial doctrine of equitable subordination, a tax claim would *rarely be subordinated*.

S. Rep. No. 95-989, 95th Cong., 2nd Sess., *reprinted in* 1978 U.S. Code Cong. & Admin. News at 5860 (emphasis added). *See also* H.R. Rep. No. 95-595, 95th Cong., 2nd Sess., *reprinted in* 1978 U.S. Code Cong. & Admin. News at 6315 (statement in support of H.R. 8200, § 510(b), which was substantially similar to § 510(c)(1) as finally enacted) ("This section . . . is not intended to limit the court's power in any way.").

The legislative history, therefore, provides no reason to believe that Congress intended tax claims to be susceptible to subordination in a narrower class of circumstances than claims generally. The conclusion follows, therefore, that if the claim is tainted by creditor misconduct *or* is of a status susceptible to subordination, *such as a penalty*, then equitable subordination is allowed. *See Burden*, 917 F.2d at 118-19; *Schultz*, 912 F.2d at 232; *Virtual Network*, 902 F.2d 1248-50. Accordingly, once the government's Section 4971 claims are properly characterized as penalty claims, they may be equitably subordinated without regard to the existence of misconduct by the taxing agency.

RELIEF REQUESTED

The method of statutory interpretation employed in this case by the United States Court of Appeals for the Sixth Circuit is clearly contrary to existing precedent of this Court and is in conflict with the decisions of other courts of appeals. In addition, the court of appeals' interpretation of the Internal Revenue Code is directly contrary to the statute's provisions. Petitioners respectfully request this Court to grant certiorari to review the patently erroneous decision of the sixth circuit below.

Respectfully submitted,

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No. ________

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1991

SAMUEL KRUGLIAK and RICHARD L. PHILLIPS,
Co-Disposition Assets Trustees for The
Mansfield Tire & Rubber Company, Debtor,
Petitioners,

v.

THE UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

APPENDIX

RECOMMENDED FOR FULL TEXT PUBLICATION
Pursuant to Sixth Circuit Rule 24

No. 90-4103

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

In Re: The Mansfield Tire & Rubber Company,
Debtor,

UNITED STATES OF AMERICA,
Plaintiff-Appellant,

-vs-

THE MANSFIELD TIRE & RUBBER COMPANY,
Defendant,

SAMUEL KRUGLIAK, Trustee;
RICHARD L. PHILLIPS, Trustee,
Defendants-Appellees.

ON APPEAL from the United States District Court for the Northern District of Ohio

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Decided and Filed August 28, 1991

Before: KENNEDY and JONES, Circuit Judges; and GIBSON, Chief District Judge.*

KENNEDY, Circuit Judge. In this case we are called upon to determine the priority to be afforded under the Bankruptcy Code to federal pension excise tax claims which have been challenged by the trustees.

In 1979, debtors Mansfield Tire and Rubber Company, Pennsylvania Tire and Rubber Company of Mississippi, Inc., and Pennsylvania Tire Company filed petitions for relief under chapter 11 of the United States Bankruptcy Code of 1978, Title 11 U.S.C. The United States filed a proof of claim asserting, *inter alia*, unsecured claims in the amount of $363,111.20 for the debtors' pension excise tax liability under section 4971(a) of the Internal Revenue Code, 26 U.S.C. § 4971(a). The United States contended that the excise tax liabilities are entitled to distributive priority under section 507(a)(7) of the Bankruptcy Code, 11 U.S.C. § 507(a)(7).[1]

The trustees objected to the pension excise tax proof of claim, asserting that the claim is not entitled to

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* The Honorable Benjamin F. Gibson, Chief United States District Judge for the Western District of Michigan, sitting by designation.

[1] That section was designated 507(a)(6) until 1984, when Congress inserted a superior category of claims as part of the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333. The pre-amendment priority scheme is applicable in this case, which was filed prior to the amendment.

priority, as it constitutes a penalty rather than a tax, and that it should therefore be subordinated to the claims of general unsecured creditors pursuant to either 11 U.S.C. § 726(a)(4) or § 510(c). The trustees then filed a motion for summary judgment on the same grounds.

The Bankruptcy Court granted summary judgment in favor of the trustees. The court determined that the government's section 4971 claim was not eligible for priority under 11 U.S.C. §507(a)(7)(E) and that the claim should be subordinated in distribution to the claims of general unsecured creditors pursuant to 11 U.S.C. § 510(c).

The District Court affirmed, agreeing that excise taxes under section 4971(a) are penalties rather than excise taxes for purposes of the Bankruptcy Code and thus were not entitled to the priority granted to excise taxes by section 507(a)(7)(E) of the Bankruptcy Code. Reasoning from its characterization of the government's claims as penalties, the District Court then held that it was proper to equitably subordinate those claims to those of general unsecured creditors pursuant to section 510(c) of the Bankruptcy Code.

The questions presented are (1) whether a federal excise tax imposed by section 4971(a) of the Internal Revenue Code is an "excise tax" entitled to priority under section 507(a)(7)(E) of the Bankruptcy Code and (2) whether a tax owed to the federal government may be equitably subordinated to other claims only upon a showing of inequitable conduct by the federal government. We answer both questions in the affirmative, and **REVERSE.**

The challenged claims stem from assessments made pursuant to 26 U.S.C. § 4971(a) resulting from the debtors' failure to meet minimum funding requirements for a pension plan. Section 4971 was enacted as part of ERISA in 1974 as a means of enforcing the minimum funding requirement of ERISA. The validity and amount of the assessments are not disputed by the trustees.

Section 4971 is located in Subtitle D of the Internal Revenue Code under the heading "Miscellaneous Excise Taxes." That section is captioned "Taxes on failure to meet minimum funding standards" and provides, in relevant part:

> (a) **Initial tax.** -- For each taxable year of an employer who maintains a plan to which section 412 applies, there is hereby imposed a tax of 10 percent . . . on the amount of the accumulated funding deficiency under the plan, determined as of the end of the plan year ending with or within such taxable year.
>
> . . . .
>
> (e) **Liability for tax.** --
>
>> (1) **In general.** -- . . . the tax imposed by subsection (a) or (b) shall be paid by the employer responsible for contributing to or under the plan the amount described in section 412(b)(3)(A).

26 U.S.C. § 4971.

The Bankruptcy Code, by section 507, provides for priority of certain claims in bankruptcy. It reads, in relevant part:

> (a) The following expenses and claims have priority in the following order:
>
> . . . .
>
>> (7) Seventh, allowed unsecured claims of governmental units; (sic) only to the extent that such claims are for --
>>
>> . . . .
>>
>> (E) an *excise tax* on --
>>
>> (i) a transaction occurring before the date of the filing of the petition for which a return, if required, is last due, under applicable law or under any extension, after three years before the date of filing of the petition; or
>>
>> (ii) if a return if not required, a transaction occurring during the three years immediately preceding the date of the filing of the petition.

The government's argument is a simple one: section 4971 assessments are "excise taxes"; section 507(a)(7)(E) says an "excise tax" is entitled to priority; therefore, section 4971 assessments are entitled to priority. The trustees argue that such assessments are actually penalties disguised as taxes and thus should not be given priority under section 507(a)(7)(E). Further, the trustees argue

that the section 4971 assessments are nonpecuniary loss penalties, which should be subordinated to the claims of general unsecured creditors.

The trustees argue that those payments which Congress defined as "excise taxes" in the Internal Revenue Code are not necessarily "excise taxes" under the Bankruptcy Code. The trustees maintain that the government is not entitled to a priority distribution for its section 4971(a) claims because, despite its label as an "excise tax," section 4971 exacts nonpecuniary loss penalties as a matter of bankruptcy law. They maintain that section 4971 claims do not satisfy the four-part test used by the courts below for determining whether a particular governmental exaction is a "tax," which test we are urged to adopt.[2]

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[2] Under the test, an exaction is a "tax" if it is:

1. An involuntary pecuniary burden, regardless of name, laid upon individuals or property;

2. Imposed by, or under authority of the legislature;

3. For public purposes, including the purposes of defraying expenses of government or undertakings authorized by it; and

4. Under the police or taxing power of the governmental unit.

The test was drawn from *In re Lorber Industries of California, Inc.*, 675 F.2d 1062, 1066 (9th Cir. 1982) (adopting the test articulated in *In re Farmers Frozen Food Co.*, 221 F. Supp. 385, 387 (N.D. Cal. 1963), *aff'd*, 332 F.2d 793 (9th Cir. 1964)). Both *Lorber* (county sewer user fees) and *Farmers* (state agricultural assessments) concerned whether *non-federal* levies constituted "taxes" for purposes of federal bankruptcy priority. In addition, those cases did not concern exactions which had

"The task of resolving the dispute over the meaning of [§ 507(a)(7)(E)] begins where all such inquiries must begin: with the language of the statute itself." *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989). In *Ron Pair*, the Supreme Court held that where the language of the Bankruptcy Code is plain, "'the sole function of the courts is to enforce it according to its terms.'" *Id.* (quoting *Caminetti v. United States*, 242 U.S. 470, 485 (1917)). The statutory language held to have plain meaning in *Ron Pair* -- a lengthy phrase in Bankruptcy Code § 506(b) containing several clauses -- is undoubtedly less plain than the language we are presented with here, the term "excise tax."

Acknowledging that the government prevails if we apply the plain language of the Bankruptcy Code, the trustees contend that "[t]he bankruptcy laws, and the laws which affect them, must be construed so as to effectuate their fundamental purposes" and that "courts are empowered to look behind the labels affixed to statutes when those labels are inconsistent with overriding legislative objectives." The trustees argue that the purpose and legislative history of section 4971 reveal that its primary goal is to achieve punitive purposes and they point out that bankruptcy law looks with disfavor on nonpecuniary loss penalties. *See* 11 U.S.C. § 507(a)(7)(G); *cf. Simonson v. Granquist*, 369 U.S. 38, 40-41 (1962) ("Enforcement of penalties against the estates of bankrupts ... would serve not to punish the delinquent taxpayer, but rather their entirely innocent creditors.") Therefore, the trustees maintain that to allow prioritization of the government's "penalty" claim is

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been labeled as "excise taxes." As we have indicated, *infra*, reliance on this line of cases in the context of a congressionally levied tax is inappropriate.

inimical to fundamental bankruptcy policy and thus we should construe the term "excise tax" in Bankruptcy Code section 507(a)(7)(E) so as not to include the excise taxes payable under 26 U.S.C. § 4971.

The Bankruptcy Code does not define "tax" or "excise tax" and therefore we are not persuaded that Congress intended to give a special bankruptcy-context meaning to those words. With respect to the regulatory nature of section 4971 excise taxes, Congress granted priority to excise tax claims without regard to whether their purpose was primarily regulatory. Indeed, many, if not most, of the excise taxes contained in Subtitles D and E of the Internal Revenue Code are intended to discourage undesirable conduct. We see no indication, either in the statute itself or in the legislative history underlying that provision, that Congress intended to deny priority to any federal excise tax.[3]

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[3] Although convinced that the plain and unambiguous language of the Bankruptcy Act supports our conclusion, we also note that the legislative history is in accord. With respect to the priority granted to "excise taxes," the history indicates that "[a]ll Federal ... taxes generally considered or expressly treated as excises are covered by this category." 124 Cong. Rec. 32398, 32416 (1978) (Rep. Edwards); 124 Cong. Rec. 33998, 34016 (1978) (Sen. DeConcini) (joint floor statements). There is no question but that Congress has expressly treated the section 4971 exaction as an "excise tax." It is referred to as a "tax" in the language of the section itself and is contained within Subtitle D of the Internal Revenue Code, entitled "Miscellaneous Excise Taxes."

Because no formal conference was held in connection with the enactment of the Bankruptcy Reform Act of 1978, the legislative statements of the sponsors serve in place of a conference committee report. *See generally* Kennedy, *Foreword: A Brief History of the Bankruptcy Reform Act*, 58

In urging their construction of section 507(a)(7)(E), the trustees argue that prioritizing the government's section 4971 claims "would afford them a distributive advantage not envisioned by the drafters of the Bankruptcy Code -- an advantage whose ultimate cost would be borne by Mansfield's innocent creditors." We find this argument specious. Section 4971 was an existing federal excise tax at the time the Bankruptcy Code drafters used the term excise tax. Although the Bankruptcy Code does not define "tax" or "excise tax" it seems to us that when Congress said "excise tax" in section 507(a)(7)(E), Congress at the very least meant to include those exactions which Congress itself had previously deemed to be federal excise taxes.

With respect to the trustees' argument that the debtors' innocent creditors will bear the cost of prioritizing the government's claims, we needn't concern ourselves with that policy decision. Congress has already made that choice. Congress chose to prioritize a host of government tax claims, including excise taxes, despite the fact that a debtor's other "innocent creditors" could be left unfulfilled. Whatever general policy against giving priority to penalty debts may exist, Congress has chosen to give priority to excise taxes without distinguishing among them based upon a court's view of their purpose or nature. This Congress clearly may do.

While the plain language of legislation is not conclusive in the "rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters," *Griffin v.*

N.C.L. Rev. 667, 676-77 (1980). The statements are treated as persuasive evidence of Congressional intent. *Begier v. I.R.S.*, 110 S. Ct. 2258, 2266 n.5 (1990).

Oceanic Contractors, Inc., 458 U.S. 564, 571 (1982), the trustees have not shown that this is one of those "rare cases."

We hold that where Congress has given unqualified priority to "excise tax[es]," as in 11 U.S.C. § 507(a)(7)(E), and Congress has deemed a particular federal exaction an "excise tax," as in 26 U.S.C. § 4971, we will not independently decide whether Congress meant "excise tax" when it said "excise tax." The District Court erred in undertaking to independently determine whether the tax due under section 4971 is in fact a tax for purposes of bankruptcy priority.[4]

We do not hold that any exaction deemed an excise tax by a body other than Congress is entitled to the same deference. In cases of state and local exactions it may be appropriate to more closely examine the particular governmental claim to determine whether it truly is in the nature of a "tax" as that term is used by Congress. This is because the question whether a particular exaction is a "tax" within bankruptcy law is a federal question. While a federal court may ultimately be called upon to decide the question where a state or local exaction is at issue, in this case we are concerned with a federal excise tax. Where Congress has exercised its constitutional power and deemed an exaction an "excise tax," the question has been answered.

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[4] The trustees also point out that the priority granted under section 507(a)(7)(E) extends only to excise taxes on "transactions." They contend that the failure to meet the minimum funding requirements for a pension plan does not constitute such a "transaction." We find no merit to this argument.

The trustees rely on *City of New York v. Feiring*, 313 U.S. 283 (1941), as the foundation for their argument that courts are free to determine for themselves whether a particular federal exaction is an "excise tax" within the meaning of the Bankruptcy Code. That reliance is untenable.

The issue presented in *Feiring* was "whether the obligation imposed upon sellers by a New York City sales tax ... is a 'tax' entitled to priority of payment" under section 64 of the Bankruptcy Act of 1898. *Id*. at 284.[5] In addressing that issue, the Court stated that "[w]hether the [New York City sales tax] is a 'tax' entitled to priority within the meaning of the statute is a federal question." *Id*. at 285 (citing *New Jersey v. Anderson*, 203 U.S. 483, 491 (1906)). In light of the fact that what constitutes a "tax" within the Bankruptcy Act is a federal question, the Court went on to analyze the New York City sales tax at issue, determining that it was a tax as a matter of federal law and was entitled to priority under section 64.

Crucial to the *Feiring* Court's decision to look beyond the designation of the exaction as a "tax" was the Court's holding that section 64 of the Bankruptcy Act was "[i]ntended to be nationwide in its application [and] nothing in the language of § 64 or its legislative history suggests that its incidence is to be controlled or varied by the particular characterization *by local law* of the *state's* demand." *Id*. at 285 (emphasis added). In other words, state and local governments may not promote their own

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[5] That section of the Bankruptcy Act afforded distributive priority to "'taxes legally due and owing by the bankrupt to the United States or any State or any subdivision thereof ...'" *Feiring*, 313 U.S. at 285.

claims within the federal priority scheme merely by characterizing them as "taxes."

The trustees and the Bankruptcy and District Courts below have failed to take account of the Supreme Court's reasoning. Consequently, they have extended the Supreme Court's holding that *state* and *local* exactions will be tested against a federal definition of "tax" for purposes of applying federal bankruptcy law to include testing those exactions which Congress itself has deemed to be taxes. The error in such an extension is illustrated when it is seen that such a holding transforms the above-quoted reasoning of the *Feiring* Court to read as follows: "Intended to be nationwide in its application, nothing in the language of [Bankruptcy Code § 507(a)(7)(E)] or its legislative history suggests that its incidence is to be controlled or varied by the particular characterization by [Congress] of the [federal] demand." *Id.* at 285. We are unaware of any intent by Congress to have its own characterizations of payments as "taxes" subject to second-guessing by the federal courts. In summary, reliance on *Feiring* is misplaced where, as here, we are concerned with Congress' characterization of an exaction as an "excise tax."

The trustees also rely on *In re Kline*, 403 F. Supp. 974 (D. Md. 1975), *aff'd*, 547 F.2d 823 (4th Cir. 1977), and *In re Unified Control Systems, Inc.*, 586 F.2d 1036 (5th Cir. 1978). In those cases the courts held that excise taxes under 11 U.S.C. § 4941 were really penalties for purposes of determining their eligibility for priority distribution under the Bankruptcy Act. In our view those cases were wrongly decided to the extent that they held that the federal courts should look beyond the characterization of Congress to determine whether an exaction is a "tax" entitled to priority under federal bankruptcy law.

The District Court in Kline held that

> [t]he name given to the exaction by the legislature is not conclusive. *New Jersey v. Anderson*, 203 U.S. 483 ... (1906) ... [T]he Supreme Court cases agree that the purpose of the particular enactment is the controlling factor. An enactment which has as its purpose the punishment of conduct perceived to be wrongful should be deemed a 'penalty' ... regardless of the terminology employed by the legislature.

Kline, 403 F. Supp. at 978. Reliance on *Anderson* and other Supreme Court decisions for the issue before us is based upon misreading the holdings of those cases.

Anderson concerned whether a New Jersey franchise tax was entitled to preferential treatment under section 64a of the Bankruptcy Act which provided priority for "all taxes legally due and owing by the bankrupt to the United States, state, county, [etc.]."[6] As a threshold matter, the Supreme Court noted that because it was applying and interpreting the federal bankruptcy statute, whether a particular debt to a governmental unit is a "tax" within the meaning of the Bankruptcy Act is a federal question. The Court then held that whether a debt is a "tax" within the Bankruptcy Act cannot be controlled by the label applied by a non-federal governmental unit. The reasoning in *Anderson* was tied to the fact that a state-defined "tax" was at issue.

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[6] Bankruptcy Act of 1898 § 64a, 30 Stat. at L. 563, chap. 541, U.S. Comp. Stat. 1901, p. 3447.

Unfortunately, the *Kline* court and others have cut loose the *Anderson* holding from its moorings by reading the *Anderson* decision as giving license to question every debt which is labelled a "tax," even where the "tax" designation has been made by Congress. Similarly, in none of the other Supreme Court cases relied upon by the *Kline* court -- *Simonson*, 369 U.S. 38; *United States v. New York*, 315 U.S. 510 (1962); *Meilink v. Unemployment Reserves Comm'n*, 314 U.S. 564 (1942); *United States v. Childs*, 266 U.S. 304 (1924); and *New York v. Jersawit*, 263 U.S. 493 (1923) -- did the Court indicate that Congress' characterization of a federal exaction as a "tax" is not conclusive for purposes of bankruptcy.

The Fifth Circuit in *Unified Control* did not purport to rely on any cases concerning taxes and bankruptcy priorities for its conclusion that "the label placed upon an imposition in a revenue measure is [not] decisive in determining its character." 586 F.2d at 1037. However, the court did discuss the broad congressional policy against allowing priority for penalties because of the resulting punishment of innocent creditors, *id*. at 1038, quoting at length from the Supreme Court's decision in *Simonson*, 369 U.S. at 38, a case also relied upon by the trustees here. We find reliance on *Simonson* misplaced in this context. In that case the Supreme Court was interpreting section 57j of the Bankruptcy Act which held that "[d]ebts owing to the United States ... as a penalty or forfeiture shall not be allowed." It was undisputed in that case that the claims at issue were characterized as "penalties" by Congress. The Court, in an opinion of less than three full pages, simply applied the plain reading of 57j to the congressional characterization of the claims to find that the asserted claims were not allowed. *Id*. at 40. *Simonson* does not support the proposition that the courts should or may disregard a congressional characterization

of a payment as a tax when a court believes that it is actually a penalty.

The trustees also point out that in *In re Jenny Lynn Mining Co.*, 780 F.2d 585 (6th Cir.), *cert. denied*, 477 U.S. 905 (1986), and *United States v. River Coal Co.*, 748 F.2d 1103 (6th Cir. 1984), this Court looked beyond the characterization of certain payments to determine whether the payments were "taxes" for purposes of bankruptcy law. However, neither *Jenny Lynn Mining* nor *River Coal* concerned the issue presented in this case, nor do those cases suggest that we should independently decide whether that which Congress has designated a "tax" is a "tax" for bankruptcy purposes.

After finding that the government's claims were actually for nonpecuniary penalties rather than for taxes, the courts below proceeded to subordinate the section 4971 claims to those of general unsecured creditors pursuant to section 510(c) of the Bankruptcy Code, despite no allegation of inequitable conduct by the government. That section provides in part:

> (c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may --
>
> > (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest[.]

The District Court based its reasoning that inequitable conduct by the subordinated claimholder is not required

on three cases: *In re Colin*, 44 Bankr. 806 (Bankr. S.D.N.Y. 1984) (subordination of punitive damage award); *In re Virtual Network Services Corp.*, 902 F.2d 1246 (7th Cir. 1990) (subordination of nonpecuniary loss tax penalties); and *In re Schultz*, No. 89-2380 (8th Cir. Aug. 21, 1990) (1990 LEXIS) (subordination of nonpecuniary loss tax penalties). *See also Burden v. United States*, 917 F.2d 115 (3d Cir. 1990) (subordination of nonpecuniary loss tax penalties). None of those cases, however, concerned the question presented here: whether claims for federal taxes, as opposed to tax penalties, may be equitably subordinated in the absence of some inequitable conduct on the part of the government. Therefore, whatever persuasive value those decisions may have had for a case concerning nonpecuniary loss penalties, they are inapposite, ~~here~~.

The trustees maintain that the legislative history surrounding section 510 supports the subordination of the government's claims here:

> It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts the development of this principle. To date, under existing law, a claim is generally subordinated only if the holder of such claim is guilty of inequitable conduct, or the claim itself is of a status susceptible to subordination, such as a penalty . . ..

124 Cong. Rec. H11089 (Sept. 28, 1978) (statement by Rep. Edwards), reprinted in 1978 U.S. Code Cong. & Admin. News 5787, 6452; 124 Cong. Rec. S17406 (Oct. 6, 1978) (statement by Sen. DeConcini), reprinted in 1978 U.S. Code Cong. & Admin. News 6505, 6521. However,

we have already rejected the very premise upon which this argument is based in holding that section 4971 liabilities are not penalties but are excise taxes within the meaning of the bankruptcy code.

The trustees further argue that the District Court correctly exercised its equitable powers to subordinate the government's claim in this case because the "essential characteristic" of section 4971 is that of a penalty rather than a tax. The trustees contend that "[t]he mere labeling of a statute as a 'tax' cannot impair the bankruptcy court's exercise of its basic equitable powers -- powers explicitly granted to it by Congress." In essence, the trustees ask us to find that Congress set out a specific and comprehensive set of priorities for payment of claims in section 507 and then intended to give bankruptcy courts in section 510(c) the power to disregard those priorities whenever the bankruptcy court's view of general equity differed from the statutory scheme. We reject that reading of section 510(c), which by its own terms is limited to "principles of equitable subordination." The legislative history makes clear that the use of that term was meant to codify "existing case law," leaving to the courts the development of the principle. We view the remarks in the legislative history that development of the principles of equitable subordination is left to the courts not as an invitation to abandon traditional principles, but as an acknowledgment that the common law is continually developing.

We continue to recognize that equitable subordination in bankruptcy may be appropriate if the claimholder is guilty of inequitable conduct or if the claim itself is of a status susceptible to subordination. We decline the appellees' invitation to extend equitable subordination under section 510(c) to include subordination of federal tax claims in the absence of some

inequitable conduct on the part of the government because claims for federal taxes are not claims of a type which are otherwise "susceptible to subordination." The courts are not free to independently decide whether the "essential characteristic" of a federal exaction is that of a tax or a penalty in order to invoke equitable subordination. If Congress has decided that a particular levy is a "tax" rather than a "penalty," for purposes of priorities in bankruptcy the matter is settled.

Accordingly, the judgment of the District Court is REVERSED. The case is REMANDED to the Bankruptcy Court for further proceedings not inconsistent with this opinion.

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

IN THE MATTER OF:	)	Case No. C87-2641A
	)	
THE MANSFIELD TIRE AND RUBBER COMPANY, et al.,	)	Bankruptcy Case No. 679-1238
	)	
Debtors,	)	Judge Sam H. Bell
	)	
UNITED STATES OF AMERICA,	)	
	)	
Plaintiff,	)	
	)	
-vs-	)	<u>O R D E R</u>
	)	
THE MANSFIELD TIRE AND RUBBER COMPANY, et al.,	)	[Filed October 2, 1990]
	)	
Defendant.	)	

This matter is before the court on appeal from the United States Bankruptcy Court for the Northern District of Ohio pursuant to 28 U.S.C. § 158. Appellant United States of America (hereinafter Appellant) has asserted that the bankruptcy court erred in granting summary judgment in favor of appellees, Co-Disposition Assets Trustees Samuel Krugliak and Richard L. Phillips (hereinafter Trustees). For the following reasons the order of the bankruptcy court is affirmed.

STATEMENT OF FACTS

On October 1, 1979, the Mansfield Tire and Rubber Company and the Pennsylvania Tire and Rubber Company of Mississippi, Inc., filed voluntary petitions for relief under chapter 11 of Title 11 of the United States Bankruptcy Code. On November 1, 1979, the Pennsylvania Tire Company also filed a petition under Chapter 11. The United States filed a proof of claim against the debtors, asserting inter alia unsecured priority claims in the amount of $363,111.20 for debtors' pension excise tax liability under § 4971(a) of the Internal Revenue Code for the tax years 1977, 1978 and 1979.

On December 30, 1985, the bankruptcy court confirmed a consolidated liquidating Chapter 11 plan of reorganization for the debtors. The Trustees filed an objection to the pension excise proof of claim on November 18, 1986. They asserted that the claim is not entitled to priority in distribution under 11 U.S.C. § 507(a)(6) (now and hereinafter § 507(a)(7)) as it constitutes a penalty rather than a tax, and that it should be subordinated pursuant to either 11 U.S.C. § 726(a)(4) or § 510(c) to the claim of general unsecured creditors. The Trustees then filed a motion for summary judgment on the same grounds.

On September 4, 1987, the bankruptcy court granted summary judgment, determining that the claim of the United States was not eligible for priority under 11 U.S.C. § 507(a)(7) and that the claim should be subordinated in distribution to the claims of general unsecured creditors pursuant to 11 U.S.C. § 510(c).

ISSUES ON APPEAL

1. Did the bankruptcy court err in holding that excise tax assessments made pursuant to 26 U.S.C. § 4971 constitute penalties rather than taxes for purposes of 11 U.S.C. § 507(a)(7)?

2. Did the bankruptcy court err in subordinating the Internal Revenue Service's claim to those of general unsecured creditors pursuant to 11 U.S.C. [§] 510(c)?

ANALYSIS

A. The Bankruptcy Court Did Not Err in Construing Section 4971 Assessments As Penalties Rather Than Taxes.

The challenged claims stem from assessments made pursuant to 26 U.S.C. § 4971(a) resulting from the debtors' failure to meet minimum funding requirements for the Mansfield Tire and Rubber Company's employees' pension plan. Section 4971 provides, in relevant part:

> (a) Initial Tax. For each taxable year of an employer who maintains a plan to which section 412 applies, there is hereby imposed a tax of 10 percent (5 percent in the case of a multiemployer plan) on the amount of the accumulated funding deficiency under the plan, determined as of the end of the plan year ending with or within such taxable year.
>
> . . .
>
> (c) Liability for tax. --

> (1) In general. -- . . . the tax imposed by subsection (a) or (b) shall be paid by the employer responsible for contributing to or under the plan the amount described in section 412(b)(3)(A).

Section 4971, in short, requires employers subject to ERISA law to meet a minimum funding standard for ERISA pension plans. "The purpose of the ERISA minimum funding requirements is to insure that pension plans will accumulate sufficient assets within a reasonable time to pay promised benefits to covered employees when they retire." International Union v. Keystone Consolidated Industries, Inc., 793 F.2d 810, 813 (7th Cir. 1986), cert. denied 479 U.S. 932, 107 S.Ct. 403.

Appellant, on appeal, contends that the correct way to characterize a § 4971 assessment is as an excise tax within the meaning of the Bankruptcy Code and thus it should be given priority under § 507(a)(7)(E). The Trustees claim that such assessments are nothing more than penalties disguised with the label "tax" and thus should not be given priority under the bankruptcy laws. It is clear that the Bankruptcy Code disallows penalty claims not in compensation for actual pecuniary loss to have priority under § 507(a). Section 507(a)(7)(G) allows only pecuniary loss penalties related to a § 507(a)(7) claim to have priority, while nonpecuniary loss penalties are subordinated to the claims of general unsecured creditors pursuant to 11 U.S.C. § 726(a)(4). Thus, the policy against punishing innocent creditors is retained from § 57(j) of the Bankruptcy Act of 1898 (debts owed to United States as penalty are disallowed "except for the amount of the pecuniary loss sustained . . ."). See also City of New York v. Feiring, 313 U.S. 283 (1941); In re United Control Systems, Inc., 586 F.2d 1036 (5th Cir.

1978); In re Kline, 403 F. Supp. 974 (D. Md. 1975) aff'd 547 F.2d 823 (4th Cir. 1977).

Section 507(a) of the Bankruptcy Code outlines the obligations of the debtor and estate entitled to priority in distribution and the order of priority. It provides, in relevant part:

> (a) The following expenses and claims have priority in the following order:
>
> . . .
>
> (7) Seventh, allowed unsecured claims of governmental units; only to the extent that such claims are for --
>
> . . .
>
> (E) an excise tax on --
>
> (i) a transaction occurring before the date of the filing of the petition for which a return, if required, is last due, under applicable law or under any extension, after three years before the date of the filing of the petition; or
>
> (ii) if a return is not required, a transaction occurring during the three years immediately proceeding the date of the filing of the petition.

11 U.S.C. § 507(a)(7)(E).

Appellant bases its claim that the § 4971 assessments are taxes within the meaning of § 507(a)(7)(E) rather than penalties on two theories.

First, appellant claims that § 4971 assessments fit the definition given taxes by Feiring. The Supreme Court in Feiring defined "taxes" for purposes of the Bankruptcy Act as "pecuniary burdens laid upon individuals or their property, regardless of their consent, for the purpose of defraying the expenses of government or of undertakings authorized by it." Feiring, 313 U.S. at 285. The court below adopted this definition as part of the following four-part test to be used in determining whether a particular assessment qualifies for treatment as a tax for bankruptcy law purposes. A tax is:

> 1. A voluntary pecuniary burden, regardless of name, laid upon individuals or property;
>
> 2. Imposed by, or under authority of the legislature;
>
> 3. For public purposes, including the purposes of defraying expenses of government or undertakings authorized by it; and
>
> 4. Under the police or taxing power of the governmental unit.

See In re Farmers Frozen Food Company, 221 F. Supp. 385, 387 (N.D. Calif. 1963); In re Lorber Industries of California, Inc., 675 F.2d 1062, 1066 (9th Cir. 1982).

In arguing that the § 4971 assessments meet the third prong of this test and the Feiring definition, appellant claims that the "incidents" of the § 4971 obligation establish its character as a tax within the meaning of Feiring. Appellant also argues that the

intention of Congress to create a tax under § 4971 is evidenced by the fact that Congress gave the "color and standing" of taxes to these obligations.

Appellant cites very little support for these conclusions. It relies on the fact that Congress entitled § 4971 "Taxes on Failure to Meet Minimum Funding Standard" and placed it in Subtitle D of the Internal Revenue Code under the heading "Miscellaneous Excise Taxes." Appellant also points to the fact that the § 4971 assessments are "self-assessing," meaning the amount assessable is definite and fixed once the deficiency amount is determined, and to the fact that the employer has all the rights of a taxpayer once the notice of deficiency is received. Finally, appellant gives significance to the fact that interest on the § 4971 excise tax begins to run on the last day prescribed for payment, a characteristic of taxes generally but not of penalties.

Appellant ignores the express congressional purpose behind § 4971 which was astutely recognized by the court below. The purpose is not to defray "the expenses of government or of undertakings authorized by it," but rather, the purpose is to inflict a penalty upon those employers who fail to meet the minimum funding requirement. A review of the legislative history of § 4971 establishes that, while Congress labeled this assessment an "excise tax," nonetheless its purpose is punitive in nature:

> The committee bill also provides new and more effective <u>penalties</u> where employers fail to meet the funding standards. In the past, an attempt has been made to enforce the relatively weak funding standards existing under present law by providing for immediate vesting of the employee's rights,

> to the extent funded, under plans which do not meet these standards. This procedure, however, has proved to be defective since it does not directly penalize those responsible for the underfunding. For this reason, the committee bill places the obligation for funding and the penalty for underfunding on the person on whom it belongs -- namely, the employer.
>
> This is achieved by imposing an excise tax where the employer fails to meet the funding standards . . .
>
> . . .
>
> Additionally, the committee believes that current sanctions on an employer for failure to adequately fund his qualified plan are inappropriate, since they may not affect an employer's decision to underfund his plan . . . to resolve this problem, the committee's bill provides an excise tax on the failure to meet the minimum funding requirements.

S. Rep. No. 383, 93rd Cong., 2nd Sess. (1974 U.S. Code Cong. & Admin. News 4890, 4909-10, 4941). See also H.Rep. No. 807, 93rd Cong., 2nd Sess. (1974 U.S. Code Cong. & Admin. News 4670, 4694-95, 4763) (emphasis added). Obviously, the purpose of § 4971 is not to defray the expenses of government, but rather to penalize employers who underfund their pension plans.

Appellant's second theory is much more convincing and raises an interesting difficulty. Two cases are relied upon by appellant for the proposition that § 4971

assessments are taxes within the meaning of § 507(a)(7)(E): In re A.C. Williams, 81 B.R. 434 (Bkrtcy. N.D. Ohio) and In re Overly-Hautz, 57 B.R. 932 (Bkrtcy. N.D. Ohio 1986), aff'd 81 B.R. 437 (N.D. Ohio 1986). The bankruptcy court below did not consider the import of these cases due to the fact that the issue of whether § 4971 liabilities are § 507(a)(7)(E) taxes was not directly controverted. Matter of Mansfield Tire & Rubber Comp., 80 B.R. 395, 398 (fn. 3)(Bkrtcy N.D. Ohio 1987).

In Overly-Hautz, at issue inter alia was whether § 4971 assessments would be entitled to administrative expense priority under § 507(a)(1). This section provides:

> (a) the following expenses and claims have priority in the following order:
>
> (1) First, administrative expenses allowed under section 503(b) of this title
>
> . . .

11 U.S.C. § 507(a)(1). Section 503(b) provides, in pertinent part:

> (b) After notice and hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including --
>
> (1)(B) any tax --
>
> (i) incurred by the estate, except a tax of a kind specified in section 507(a)(7) of this title . . .

11 U.S.C. [§] 503(b)(1)(B). The same issue faced the court in Williams.

The Overly-Hautz court denied administrative expense priority to the claimants while the Williams court granted it. The difference was that in Overly-Hautz the § 4971 liability was incurred prepetition, while in Williams it was incurred postpetition. It is well-settled that only taxes or other debts incurred postpetition can be administrative expenses under 503(b)(1)(B). Prepetition taxes are not "incurred by the estate" due to the fact no estate exists prepetition. See In re United Trucking Service, Inc., 851 F.2d 159, 161 (6th Cir. 1988).

Appellant contends that for the court in Williams and Overly-Hautz to have reached the issue of whether the § 4971 liabilities would be deemed administrative expenses, it must have implicitly held that those liabilities are taxes and not penalties for § 507(a) priority purposes. Certainly, the aforementioned principle which disallows penalty claims from enjoying priority status and subordinates them to the claims of general unsecured creditors applies to § 507(a)(1) as well as § 507(a)(7). Simply put, penalty claims not in compensation for pecuniary loss are not meant to have priority. If a "tax" claim is truly a penalty and thus is denied § 507(a)(7) status, it obviously could never be placed within § 507(a)(1). Instead, it would be subordinated pursuant to § 726(a)(4) or § 510(c).

Appellant's argument is well reasoned and persuasive. Ultimately, however, the previously mentioned explicit legislative intent behind § 4971 prevails in this controversy. Thus, to the extent that the court in either Williams or Overly-Hautz concluded that § 4971 liabilities could be awarded priority under § 503(b)(1)(B) and

§ 507(a)(1), it was erroneous. Such "taxes" are penalties for § 507(a) purposes.

This conclusion is buttressed by a line of cases which have held likewise. See In re Airlift International, Inc., 97 B.R. 664 (Bkrtcy. S.D. Fla. 1989) aff'd E.B.C. 1675, No. 89-1053 - CV (S.D. Fla. May 31, 1990) (LEXIS); In re Wheeling-Pittsburgh Steel Corp., 103 B.R. 672 (W.D. Pa. 1989); In re Bertsch & Company, Inc., No. IP84-4366RA (S.D. In. Aug. 15, 1988) (LEXIS). These cases cite Mansfield, the very case under scrutiny here, as authority, and this court also believes the bankruptcy court below to be correct in its analysis as to the interplay between 26 U.S.C. § 4971 and 11 U.S.C. § 507(a).

B. The Bankruptcy Court Did Not Err In Subordinating Appellant's Claim To Those Of General Unsecured Creditors.

Appellant recognizes the authority the bankruptcy courts possess to subordinate non-pecuniary loss penalty claims to those of general unsecured creditors. However, appellant argues that Congress intended § 4971 assessments to be taxes within the meaning of the Bankruptcy Code in order to avoid this result. It argues that the subordination of the pension excise claim would create the incentive for corporations operating in bankruptcy to underfund their pension plans.

Appellant cites to no legislative history or other authority to support such an interpretation. Furthermore, the very premise upon which this argument is based, that Congress intended § 4971 liabilities to be taxes, has already been rejected. The legislative history clearly shows that Congress enacted § 4971 primarily for punitive purposes.

The bankruptcy court below held that 11 U.S.C. § 510(c) may properly be invoked to subordinate appellant's claim. § 510(c) provides:

> (c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may --
>
> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of another (sic) allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
>
> (2) order that any lien securing such a subordinated claim be transferred to the estate.

The court based its reasoning upon a reading of In re Colin, 44 B.R. 806 (Bkrtcy. S.D.N.Y. 1984). Colin held that a punitive damages claim could be subordinated under § 510(c) even though inequitable conduct on the part of the creditor was lacking, and based this holding on the legislative history of § 510(c):

> It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally subordinated only if the holder of such claim is guilty of inequitable conduct, or the claim itself is of a status susceptible to subordination, such as a penalty or a claim for damages arising from

> the purchase or sale of a security of the debtor.

124 Cong.Rec. H11,089-H11,117 (Sept. 28, 1978), reprinted in 1978 U.S. Code Cong. & Admin. News 5787, 6452 (emphasis added). See also 124 Cong.Rec. S17,403-S17,434 (Sept. 28, 1978), reprinted in 1978 U.S. Code Cong. & Admin. News 5787, 6521. The court also based its holding on the principle that innocent creditors should not be made to suffer for the wrongdoing of the debtor:

> If, in this case, punitive damages are to be paid, not by the alleged wrongdoer, but by his estate, the purpose of the penalty is not served. The effect would be to force innocent creditors sharing in the debtor's assets to pay for his wrongdoing. Matter of GAC Corporation, 681 F.2d 1295, 1301 (11th Cir. 1982). Such a result is clearly untenable, and patently inequitable.

Colin, 44 B.R. at 810.

Two recent Circuit Court of Appeals have followed this line of reasoning, In re Virtual Network Services Corp., 902 F.2d 1246 (7th Cir. 1990), and In re Schultz, No. 89-2380 (7th Cir. Aug. 21, 1990) (LEXIS). In Virtual Services Network Corp., the debtor filed for Chapter 11 bankruptcy relief. The IRS filed a proof of claim against the estate, part of which represented pre-petition tax penalties which the IRS identified as a general unsecured claim. The bankruptcy court concluded that the equitable subordination principles did not operate in this case and ruled that the IRS' claims must be considered on a par status with other general unsecured creditors' claims. The

district court reversed and ordered equitable subordination pursuant to § 510(c).

In affirming the district court, the Seventh Circuit disagreed with the IRS' contention that equitable subordination should only be imposed where there is some wrongful conduct on the part of the creditor, which had been the rule prior to the Bankruptcy Reform Act of 1978. The court found In re Stirling Homex Corp., 579 F.2d 206 (2d Cir. 1978), to be especially significant because the court there subordinated the claims of innocent defrauded shareholders to those of general unsecured creditors. Stirling Homex Corp. was decided a few months before passage of the Bankruptcy Act of 1978, and the Virtual Network Services Corp. court reasoned that "the principal managers of the bill were aware of this decision and its implications prior to passage of the section." Virtual Services Network Corp., 902 F.2d at 1249. See also Airlift; In re Burden, 109 B.R. 107 (E.D. Pa. 1989); In re Merwede, 84 B.R. 11 (Bkrtcy. D. Conn. 1988); In re A.H. Robins Co., Inc., 89 B.R. 555 (Bkrtcy. E.D. Va. 1988); In re Quality Sign Co., Inc., 51 B.R. 351 (Bkrtcy. S.D. Ind. 1985).

Ultimately, Virtual Services Network Corp. held that it is the duty of the courts to interpret the meaning of "equitable subordination."

> After considering the congressional statements and legislative history and scheme, we agree with the district court that Congress intended the courts to "develop" the "principles of equitable subordination." We further conclude, as did the district court, that the principles of equitable subordination are broader than the doctrine

> which developed prior to § 510(c)(1)'s enactment. It is clear that equitable subordination no longer requires, in all circumstances, some inequitable conduct on the part of the creditor.

Virtual Services Network Corp., 902 F.2d at 1249-1250.

In Schultz, the debtor filed for Chapter 11 relief and the government filed a proof of claim which included a negligence penalty for the underpayment of taxes. The bankruptcy court subordinated the negligence penalty to the claims of general unsecured creditors, and the district court affirmed.

In affirming the district court, the Eighth Circuit attached significance to the fact that "Congress ultimately rejected a Senate version of section 510(c)(1) that would have expressly exempted governmental tax claims from equitable subordination. S. Rep. No. 989, 95th Cong., 2d Sess. 74, reprinted in 1978 U.S. Code Cong. & Admin. News 5787, 5860." Schultz, 1990 U.S. App. LEXIS at 7. The court also adopted the reasoning of Virtual Services Network Corp. regarding the significance of the Stirling Homex Corp. decision. Id., at 9. Furthermore, the court found the aforementioned excerpt from the legislative history of § 510(c) to be telling, especially the remark that penalties are susceptible of subordination. Id., at 8.

Ultimately, the court concluded:

> Consequently, we agree with the district court that under the facts of this case the general unsecured creditors who suffered actual losses should receive preference over the Government's claim for a non-pecuniary

> loss tax penalty in this liquidating chapter 11. Certainly, this accords with the legislative history of the Bankruptcy Reform Act, which generally prefers claims for actual losses over purely punitive claims.

Schultz, 1990 U.S. App. Lexis 14523 at 11. See also Airlift; In re Burden, 109 B.R. 107 (E.D. Pa. 1989); Bertsch; In re Merwede, 84 B.R. 11 (Bkrtcy. D. Conn. 1988).

In sum, the bankruptcy court below did not err in subordinating appellant's claim pursuant to 11 U.S.C. § 510(c).

CONCLUSION

For the foregoing reasons, the judgment of the bankruptcy court below granting summary judgment is hereby AFFIRMED.

/s/ Sam H. Bell
SAM H. BELL
UNITED STATES
DISTRICT JUDGE

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

IN THE MATTER OF:	)	JUDGE SAM H. BELL
	)	
MANSFIELD TIRE AND RUBBER COMPANY USA,	)	
	)	
Plaintiff(s),	)	
	)	CIVIL ACTION
-vs-	)	
	)	NUMBER C87-2641-A
THE MANSFIELD TIRE AND RUBBER COMPANY, et al.,	)	
	)	
Defendant(s).	)	ORDER

The court having filed its order of decision of the matters in this action, therefore, pursuant to Fed. R. Civ. P. 58,

IT IS ORDERED that this action is hereby terminated.

/s/ Sam H. Bell
UNITED STATES
DISTRICT JUDGE

[Filed October 2, 1990]

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF OHIO

IN THE MATTER OF:	)	
	)	
THE MANSFIELD TIRE &	)	CASE NO. 679-01238
RUBBER COMPANY	)	(CONSOLIDATED)
PENNSYLVANIA TIRE	)	
AND RUBBER COMPANY	)	MEMORANDUM OF
OF MISSISSIPPI, INC.	)	DECISION RE:
PENNSYLVANIA TIRE	)	MOTION FOR
COMPANY	)	SUMMARY
	)	JUDGMENT
DEBTOR.	)	

* *

Made at Canton, Ohio this 3rd day of September, 1987.

Appearances: H. Jeffrey Schwartzberg, Esq. of Benesch, Friedlander, Coplan & Aronoff, Cleveland, Ohio; and David Simiele, Esq. of Krugliak, Wilkins, Griffiths & Dougherty, Canton, Ohio, for the movants, the Co-Disposition Assets Trustees and Joanne C. Rutkowski, Esq., Washington, D.C., Trial Attorney for the respondents, the United States of America, Internal Revenue Service.

Presently pending before the court is a Motion for Summary Judgment filed on behalf of the confirmed

Chapter 11 Co-Distribution Assets Trustees (Trustees) in support of their objection to certain claims of the United States of America, Internal Revenue Service (Government or IRS). The Trustees dispute the priority status of the Government's claims for pre-petition "excise taxes" imposed pursuant to 26 U.S.C. § 4971.

The relevant facts are not in controversy. The Mansfield Tire & Rubber Company and a related company, The Pennsylvania Tire and Rubber Company of Mississippi, Inc., filed voluntary petitions for relief under Chapter 11 of Title 11 of the United Code on October 1, 1979. Shortly thereafter, on November 1, 1979, another related company, The Pennsylvania Tire Company, Inc., sought protection under bankruptcy law. On February 6, 1980, the United States filed a proof of claim for pre-petition withholding and Federal Insurance Contribution Act (FICA) taxes. During the pendency of the bankruptcy cases, the IRS "supplemented" its claim several times to add a total of $363,111.20 in Section 4971 excise liabilities for the years 1977-79 as unsecured priority claims.[7]

On December 30, 1985, a consolidated liquidating Chapter 11 plan of reorganization was confirmed by the court. Under the terms of the plan an Assets Disposition Trust was established in which all assets of the estates

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[7] The Government's original proof of claim filed on February 6, 1980 asserted only liabilities for withholding and FICA taxes. The IRS' first supplement to its proof of claim was submitted on May 19, 1980. and added $315,208.00 in excise obligations. The second supplement sought only additional FICA and withholding taxes. The November 26, 1983 third supplement to the proof of claim requested allowance of additional Section 4971 liabilities in the amount of $16,061.20, while the fourth supplement demanded $31,842.00 further excise obligations and was filed on June 4, 1981.

were vested. The Co-Disposition Assets Trustees, Richard L. Phillips and Samuel Krugliak, filed an objection to the Government's proof of claim on November 18, 1986. Several months thereafter, the Trustees filed the instant Motion for Summary Judgment. The IRS responded and filed a Memorandum in Opposition to the Trustees' motion. The Trustees then requested and were granted leave to file a reply brief.

ISSUES

1. Do assessments imposed by the United States Government pursuant to 26 U.S.C. § 4971 constitute "taxes" within the meaning of Section 507(a)(6)[8] of the Bankruptcy Code?

2. Should the IRS' claim for "excise taxes" pursuant to 26 U.S.C. § 4971 be subordinated to claims of other creditors pursuant to Section 726(a)(4) or Section 510(c) of the Bankruptcy Code?

DISCUSSION

A.

Since the Act of 1800, debts due the United States have been granted priority status in bankruptcy cases. See generally, Collier on Bankruptcy para. 507.01 (15th ed. 1987). Section 507(a) of the Bankruptcy Code outlines

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8 The Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 358 (1984) redesignated Section 507(a)(6) as Section 507(a)(7). However, this amendment applied only to cases filed 90 days after July 10, 1984 and, accordingly, the court will refer to Section 507(a)(6) as it existed prior to the 1984 Amendments.

those obligations entitled to priority in distribution and the order of priority in a bankruptcy estate and provides in relevant part:

> The following expenses and claims have priority in order:
>
> . . .
>
> > (6) Sixth, allowed unsecured claims of governmental units, only to the extent that such claims are for --
> >
> > . . .
> >
> > > (G) a penalty related to a claim of a kind specified in this paragraph and in compensation for actual pecuniary loss.

"All Federal, State or local taxes generally considered or expressly treated as excises are covered by this category, including sales taxes, estate and gift taxes, gasoline and special field taxes, and wagering and truck taxes." 124 Cong. Rec. 11,112 (1978), 3 Collier on Bankruptcy, supra, para. 507.04[7][f].

The Trustees argue that the assessments before the court are not "taxes" but are instead penalties not in compensation for an actual pecuniary loss. Therefore, the Trustees assert that the Government's claim is not entitled to priority treatment under bankruptcy law. In addition, the Trustees contend that the claims should be subordinated pursuant to 11 U.S.C. § 726(a)(4) or, alternatively, 11 U.S.C. § 510(c). The IRS opposes the

Trustees' motion, maintaining that the liabilities in question are expressly labeled "excise taxes" and further asserts that the "pecuniary burden imposed by Section 4971(a) functions for the purpose of defraying the expenses of government or of undertakings authorized by it" and is therefore a tax. Memorandum of Law in Opposition to Trustees' Motion for Summary Judgment at p. 5 citing New York v. Feiring, 313 U.S. 283, 285 (1941).

The Government's claim arises from application of 26 U.S.C. § 4971(a) which provides:

> **Taxes on failure to meet minimum funding standards.**
>
> (a) **Initial tax.** For each taxable year of an employer who maintains a plan to which section 412 applies, there is hereby imposed a tax of 5 percent on the amount of the accumulated funding deficiency under the plan, determined as of the end of the plan year ending with or within such taxable year. The tax imposed by this subsection shall be paid by the employer responsible for contributing to or under the plan the amount described in section 412(b)(3)(A).
>
> (b) **Additional tax.** In any case in which an initial tax is imposed by subsection (a) on an accumulated funding deficiency and such accumulated funding deficiency is not corrected within the correction period, there is hereby imposed a tax equal to 100 percent of such accumulated funding deficiency to the extent not corrected. The

> tax imposed by this subsection shall be paid by the employer described in subsection (a).

The present obligations stem from imposition by the IRS of the Section 4971(a) 5 percent tax on funding deficiencies for the years 1977-79.

Both of the Trustees' arguments are founded upon the long standing, broad Congressional policy against punishing the innocent creditors of the bankrupt. Section 57j of the Bankruptcy Act of 1898 was reflective of this policy. See, In re Unified Control Systems, Inc., 586 F.2 (sic) 1036, 1038 (5th Cir. 1978) citing U.S. v. Moore, 366 F.2d 243 (5th Cir. 1966); In re Kline, 403 F. Supp. 974, 977 (D. Md. 1975) aff'd 547 F.2d 823 (4th Cir. 1977). Under Section 64(a) of the Bankruptcy Act, debts due to the United States were entitled to priority, but Section 57j effectively limited the priority treatment of those obligations:

> Debts owing to the United States or to any State or any subdivision thereof as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued on the amount of such loss according to law.

In essence, then, application of Section 57j gave priority treatment to only those government claims which were in compensation for an actual pecuniary loss. Thus, debts due to the federal government were scrutinized by the courts to ascertain whether they were in reality penalties

not entitled to allowance in the bankruptcy case. See e.g., New York v. United States, 315 U.S. 510 (1941). Although complete disallowance of penalty claims was eliminated with the enactment of the Bankruptcy Code, the policy of protecting innocent creditors from the impact of punitive debts was continued. Section 507(a)(6)(G) permits only pecuniary loss penalties related to a Section 507(a)(6) claim to enjoy priority treatment, while Section 726(a)(4) subordinates nonpecuniary loss claims of other creditors. See, 3 Collier on Bankruptcy, supra, para. 507.04[7][h], In re Compton Corp., 40 B.R. 875 (Bankr. N.D. Texas 1984).

It is well settled that the issue of whether an obligation constitutes a "tax" for purposes of the Bankruptcy Code is a federal question. New Jersey v. Anderson, 203 U.S. 483, 491 (1906); New York v. Feiring, supra, at 285. Further, it is abundantly clear that the mere labeling of an exaction as a tax is not determinative of its character. In re Kline, supra, at 978 citing New Jersey v. Anderson, supra; In re Unified Control Systems, Inc. supra at 1037.

The United States Supreme Court has defined a tax for purposes of the Bankruptcy Code "as a pecuniary laid upon individuals or their property regardless of their consent, for the purposes of defraying expenses of government or undertakings authorized by it." City of New York v. Feiring, supra at 285. Accordingly, courts have articulated a four-part test to determine whether a particular assessment qualifies for treatment as a tax for bankruptcy law purposes:

> 1. A voluntary pecuniary burden, regardless of name, laid upon individuals or property;

2. Imposed by, or under authority of the legislature;

3. For public purposes, including the purposes of defraying expenses of government or undertakings authorized by it; and

4. Under the police or taxing power of the governmental unit.

In re Farmers Frozen Food Company, 211 F. Supp. 385 (N.D. Calif. 1963); In re Lorber Industries of California, Inc., 675 F.2d 1062, 1066 (9th Cir. 1982); In re Skjonsby Truck Line, Inc., 39 B.R. 971 (Bankr. D. N.D. 1984).

Numerous cases have addressed the issue of whether an obligation due to a federal, state or local government is a "tax" within the meaning of the Bankruptcy Code and have included such assessments as workers' compensation premiums, see In re Smith Jones, 36 B.R. 408 (Bankr. D. Minn. 1984) (not a tax); In re Beaman, 9 B.R. 539 (Bankr. D. Or. 1980) (tax); In re Int'l Automated Mach., Inc., 9 B.R. 575 (Bankr. N.D. Ohio 1981) (tax); In re Payne, 27 B.R. 809 (Bankr. D. Kan. 1983) (not a tax); In re Pan American Paper Mills, Inc., 618 F.2d 159 (1st Cir. 1980) (tax); unemployment benefits, In re Garden and Steak House, 22 B.R. 830 (Bankr. N.D. Ohio 1982) (tax); In re Skjonsby Truck Line, Inc., supra, (tax); In re Federal Insulation Development Corp., 14 B.R. 362 (Bankr. S.D. Ohio 1981) (forfeiture of 10% of overdue unpaid balance is not a tax); water charges, In re Adams, 40 B.R. 545 (E.D. Pa. 1984) (not a tax); McDowell v. City of Barberton, 38 F.2d 786 (6th Cir. 1930) (tax); garbage fees, In re Ayala, 35 B.R. 651 (Bankr. D. Utah 1983); poultry inspection fees, In re South

Atlantic Packers, 28 B.R. 80 (Bankr. D. S.C. 1983) (not a tax); self-dealing "excise taxes," In re Unified Control Systems, Inc., supra (not a tax); In re Kline, supra, (not a tax); and reclamation "fees," In re Jenny Lynn Mining Co., 780 F.2d 585 (6th Cir. 1986) cert. denied ___ U.S. ___, 106 S.C. 3276, 91 L.Ed. 2d 566 (1986) (not a tax); U.S. River Coal Co., Inc. (sic), 748 F.2d 1103 (6th Cir. 1984) (tax).

Under the four-part analysis, the difficulty encountered by those who would equate taxes with punitive assessments lies principally with the third requirement. "A tax is an enforced contribution to provide for the support of government," whereas a penalty "is an exaction imposed by statute as punishment for an unlawful act." U.S. v. La Franca, 282 U.S. 568 (1931). The Trustees argue that the purpose of the statute at hand is punitive and therefore not a tax while the Government asserts that the statute "functions for the purpose of defraying expenses of government or of undertakings authorized by it" and constitutes a tax. No authority is given by the Government to support its proposition.[9]

Two cases have dealt with a strikingly similar statute, 26 U.S.C. § 4941,[10] which imposes a "tax" on self-

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[9] The cases cited by the IRS, In re Overly Hautz, 57 B.R. 932 (Bankr. N.D. Ohio 1986) aff'd No. CV86-853 (N.D. Ohio April 14, 1987); In re Unimet Corp., No. 685-00240 (Bankr. N.D. Ohio Nov. 17, 1986) and In re A.C. Williams Co., No. 581-00489 (Bankr. N.D. Ohio 1986) are inapplicable as the issue of whether the Section 4971 liabilities were taxes was not controverted.

[10] Sec. 4941. TAXES ON SELF-DEALING.
(a) **Initial taxes.**

dealing between a "disqualified person" and a private foundation. In re Unified Control Systems, Inc., supra; In re Kline, supra. Like the Section 4971 exaction, Section 4941 bases the amount of tax due on a percentage of the amount involved and levies an additional assessment if the misdoing is not corrected within a specified period of time. In Kline, the court held that the main inquiry in determining whether or not an exaction is a penalty should be directed to the purpose of the statute. In re Kline, supra, at 977 (citation omitted). After reviewing the relevant Internal Revenue Code Sections and accompanying legislative history, the court concluded:

> An enactment which has as its purpose the punishment of conduct perceived as

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(1) On self-dealer. There is hereby imposed a tax on each act of self-dealing between a disqualified person and a private foundation. The rate of tax shall be equal to 5 percent of the amount involved with respect to the act of self-dealing for each year (or part thereof) in the taxable period. The tax imposed by this paragraph shall be paid by any disqualified person (other than a foundation manager acting only as such) who participates in the act of self-dealing. In the case of a government official (as defined in section 4946[c]), a tax shall be imposed by this paragraph only if such disqualified person participates in the act of self-dealing knowing that it is such an act.

(2) On foundation manager. In any in which a tax is imposed by paragraph (l), there is hereby imposed on the participation of any foundation manager in an act of self-dealing between a disqualified person and a private foundation, knowing that it is such an act, a tax equal to 2 1/2 percent of the amount involved with respect to the act of self-dealing for each year (or part thereof) in the taxable period, unless such participation is not willful and is due to reasonable cause. The tax imposed by this paragraph shall be paid by any foundation manager who participated in the act of self-dealing.

> wrongful should be deemed a "penalty" under § 57j regardless of the terminology employed by the legislature. A measure which has as one of its substantial purposes the raising of revenue presents a more complex problem; in such a case, terminology may play an important role, see United States v. Childs, supra; United States v. New York, supra. In this case, however, the sole substantial purpose of §§ 4941 and 4944 was to penalize wrongful conduct. Although such penalties are well justified to prevent abuses by foundation managers and other disqualified persons, it would fly in the face of the purpose of § 57j of the Bankruptcy Act to give such assessments a priority over the claims of entirely innocent creditors, except insofar as the government can show pecuniary loss.

Id. at 978.

Any doubts about the purpose of the statute at bar, Section 4971, are clearly resolved by a review of the relevant legislative history accompanying its enactment. Both the House and Senate Reports confirm the punitive aim of the legislation:

> The bill also provides new and more effective penalties where employers fail to meet the funding standards. In the past, an attempt has been made to enforce the relatively weak funding standards existing under present law by providing for immediate vesting of the employees' rights, to the extent funded, under plans which do

> not meet these standards. This procedure, however, has proved to be defective since it does not directly penalize those responsible for the underfunding. For this reason, the committee bill places the obligation for funding and the penalty for underfunding on the person on whom it belongs -- namely, the employer.

H.R. Rep. No. 807, 93rd Cong., 2nd Sess. reprinted 1974 U.S. Code Cong. & Admin. News 4694; see also S. Rep. No. 383, 93rd Cong., 2nd Sess. reprinted in 1974 U.S. Code Cong. & Admin. News 4909. The congressional committee reports further provide:

> Additionally, the committee believes that current sanctions on an employer for failure to adequately fund his qualified plan are inappropriate since they may not affect an employer's decision to underfund his plan. For example, an employer may not feel any reason to make the minimum required contributions to his plan if the only consequence of underfunding is to give his employees vested rights in the amounts that are already funded. To resolve this problem, the committee's bill provides an excise tax on the failure to meet the minimum funding requirements.

S. Rep. No. 383, 93rd Cong., 2nd Sess. reprinted in 1974 U.S. Code Cong. & Admin. News 4941; see also, H.R. Rep. No. 807, 93rd Cong., 2nd Sess. reprinted in 1974 U.S. Code Cong. & Admin. News 4740.

Of course, in the broadest sense, Section 4971 assessments will help alleviate any burdens incurred by the federal government as a result of an employer's default in pension plan contributions. However, the court notes that an assessment is levied regardless of whether the funding deficiency is eventually corrected or whether the government ultimately assumes responsibility for payments to be made under the plan. Further, such a broad construction would effectively eliminate any meaning to the third part of the test, as almost every exaction imposed by the government would qualify. Finally, no facts or authority in support of its position have been offered by the IRS.

Accordingly, the court holds that assessments imposed by he federal government pursuant to 26 U.S.C. § 4971 are for punitive purposes and therefore do not constitute "taxes" within the meaning of Section 507(a)(6) of the Bankruptcy Code.

The issue then becomes whether the Government's claim qualifies under Section 507(a)(6)(G) as a pecuniary loss penalty. The previous discussion exemplifies that the assessments are clearly not in compensation for an actual pecuniary loss and, accordingly, the court finds that the assessments are not entitled to priority under Section 507(a)(6)(G) of the Bankruptcy Code.

B.

The Trustees urge the court to subordinate the claim of the Internal Revenue Service to the claims of other general unsecured creditors. They assert that Section 726(a)(4) or, alternatively, Section 510(c)(1) of the Bankruptcy Code operate to subordinate the

Government's claim. No opposition has been proffered on behalf of the IRS with respect to this request.

Section 726(a) of the Bankruptcy Code provides in relevant part:

> Except as provided in section 510 of this title, property of the estate shall be distributed
>
> (1) first, in payment of claims of the kind specified in, and in the order specified in, section 507 of this title;
>
> (2) second, in payment of any allowed unsecured claim, other than a claim of a kind specified in paragraph (1), (3) or (4) of this subsection, proof of which is
>
> (A) timely filed under section 501(a) of this title;
>
> (B) timely filed under section 501(b) or 501(c) of this title; or
>
> (C) tardily filed under section 501(a) of this title, if --
>
> (i) the creditor that holds such claim did not have notice or actual knowledge of the case in time for timely filing of a proof of such claim under section 501(a) of this title; and

(ii) proof of such claim is filed in time to permit payment of such claim;

(3) third, in payment of any allowed unsecured claim proof of which is tardily filed under section 501(a) of this title, other than a claim of the kind specified in paragraph (2)(C) of this subsection;

(4) fourth, in payment of any allowed claim, whether secured or unsecured, for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty, forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim;

(5) fifth, in payment of interest at the legal rate from the date of the filing of the petition, on any claim paid under paragraph (1), (2), (3), or (4) of this subsection; and

(6) sixth, to the debtor.

Although Section 726(a) is applicable by its literal terms only to Chapter 7 liquidation cases, a few courts have found that it applies to liquidating plans under Chapter 11 as well. See, In re Erlin Manor Nursing Home, Inc., 36 B.R. 672 (Bankr. Mass. 1984); In re Compton Corp., supra. See also, 3 Collier on Bankruptcy para. 726.01 (15th ed. 1987). However, at least one court has found

expressly to the contrary. See, In re Colin, 44 B.R. 806 (Bankr. S.D.N.Y. 1984).

The court finds that it need not become embroiled in this controversy as Section 510(c) provides an appropriate vehicle by which to subordinate the Government's claim. Section 510(c) provides:

> Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may --
>
> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
>
> (2) order that any lien securing such a subordinated claim be transferred to the estate.

Section 510(c) appears to codify case law which had developed in the absence of express statutory authority, to allow the bankruptcy court to subordinate claims under principles of equity.

The issue of whether a penalty claim could be subordinated under Section 510(c) in a Chapter 11 case absent fraud or misconduct was amply addressed by the bankruptcy court in In re Colin, supra:

> "Principles of equitable subordination" is not without limit or

meaning. The classic case for equitable subordination involves inequitable conduct by the claimant resulting in injury to other creditors. See, Matter of Mobile Steel Co., 563 F.2d 692, 699-700 (5th Cir. 1979); e.g., Matter of All Products Co., 32 B.R. 811, 815, 10 B.C.D. 1363, 9 C.B.C.2d 438 (Bankr. E.D. Mich. 1983). Where the Swift trustee errs, however, is in his suggestion that Congress determined that inequitable conduct represents the exclusive basis for equitable subordination under § 510(c). Subordination under the former Bankruptcy Act, however, was not so limited. Certain claims could be subordinated by virtue of their nature. See, In the Matter of Stirling Homex Corp., 579 F.2d 206 (2d Cir. 1978). The legislative history, moreover, reveals that Congress intended the bankruptcy courts to develop the concept and envisioned that penalty claims by their very nature, are to be subordinated:

> It is intended that the term 'principles of equitable subordination' follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally subordinated only if the holder of such claim is guilty of inequitable conduct, or the claim itself is of a status susceptible to subordination, such as a

> penalty or a claim for damages arising from the purchase or sale of a security of the' debtor.

112 Cong. Rec. H 11,095 (Sept. 28, 1978); S 17, 412 (Oct. 6, 1978).

Punitive damages claims are penalty claims. They are imposed, not to afford redress, but to deter future wrongful conduct. Frank Irey, Jr., Inc. v. Occupational Safety and Health Review of Comm'n, 519 F.2d 1200 (3d Cir. 1975) aff'd 430 U.S. 442, 97 S.Ct. 1261, 51 L. Ed. 2d 464 (1976); Collins v. Brown, 268 F. Supp. 198 (D.D.C. 1967); Sullivan v. Associated Billposters & Distributors, 6 F.2d 1000 (2d Cir. 1925). If, as in this case, punitive damages are to be paid, not by the alleged wrongdoer, but by his estate, the purpose of the penalty is not served. The effect would be to force innocent creditors sharing in the debtor's assets to pay for his wrongdoing. Matter of GAC Corporation, 681 F.2d 1295, 1301 (11th Cir. 1982). Such a result is clearly untenable, and patently inequitable.

Colin, supra at 810 (emphasis added). The court concurs with the rationale expressed by the Colin court as it pertains to the application of Section 510(c) to penalty claims. The court finds it inequitable to permit the federal government to, effectively, punish innocent creditors of the estate for wrongs inflicted by the now defunct corporations. Accordingly, the court will

subordinate the claim of the United States Government to the general unsecured creditors.

CONCLUSION

Based upon the foregoing analysis, the court holds that assessments levied by the United States Government, Internal Revenue Service pursuant to 26 U.S.C. § 4971 are not for the "purpose of defraying expenses of the government or undertakings authorized by it" but rather to sanction an employer who fails to make minimum pension plan funding contributions, and, accordingly, is not a tax within the meaning of Section 507(a)(6) of the Bankruptcy Code. The court further finds that principles of equity under Section 510(c) of the Bankruptcy Code requires the court to subordinate the claim of the Government for assessments made under Section 4971 of the Internal Revenue Code to the claims of other general unsecured creditors.

An order consistent herewith shall issue.

/s/ James H. Williams
UNITED STATES
BANKRUPTCY JUDGE

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF OHIO

IN THE MATTER OF:	)	
	)	
THE MANSFIELD TIRE &	)	CASE NO. 679-01238
RUBBER COMPANY	)	(CONSOLIDATED)
PENNSYLVANIA TIRE	)	
AND RUBBER COMPANY	)	
OF MISSISSIPPI, INC.	)	
PENNSYLVANIA TIRE	)	
COMPANY	)	ORDER
	)	
DEBTOR.	)	

* *

Made at Canton, Ohio this 3rd day of September, 1987.

For the reasons set forth in the accompanying Memorandum of Decision, the court finds the Motion for Summary Judgment filed on behalf of the Co-Distribution Assets Trustees against the United States of America, Internal Revenue Service to be well taken. It is therefore

ORDERED that the Motion for Summary Judgment filed on behalf of the Co-Distribution Assets Trustees against the United States of America, Internal Revenue Service is hereby GRANTED.

IT IS FURTHER ORDERED that the claim that the United States of America, Internal Revenue Service filed for liabilities under 26 U.S.C. § 4971 is hereby declared nonpriority and subordinated to the claims of the

general unsecured creditors, pursuant to the provisions of 11 U.S.C. § 510(c).

/s/ James H. Williams
UNITED STATES
BANKRUPTCY JUDGE

STATUTORY PROVISIONS AT ISSUE

BANKRUPTCY CODE PROVISIONS

§ 507. Priorities.

(a) The following expense and claims have priority in the following order:

***

(7) Seventh, allowed unsecured claims of governmental units, only to the extent that such claims are for --

***

(E) An excise tax on --

(i) a transaction occurring before the date of filing of the petition for which a return, if required, is due, under applicable law or under any extension, after three years before the date of the filing of the petition; or

(ii) if a return is not required, a transaction occurring during the three years immediately preceding the date of the filing of the petition;

11 U.S.C. § 507(a)(7)(E).

§ 510. Subordination.

(c) Notwithstanding subsections (a) and (b) of this section, after notice and hearing, a court may --

> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim . . ..

11 U.S.C. § 510(c)(1).

INTERNAL REVENUE CODE PROVISIONS

§ 4971. Taxes on failure to meet minimum funding standards.

(a) **Initial Tax.** For each taxable year of an employer who maintains a plan to which Section 412 applies, there is hereby imposed a tax of 5 percent on the amount of the accumulated funding deficiency under the plan, determined as of the end of the plan year ending with or within such taxable year. The tax imposed by this subsection shall be paid by the employer responsible for contributing to or under the plan the amount described in Section 412(b)(3)(A).

(b) **Additional Tax.** In any case in which an initial tax is imposed by subsection (a) on an accumulated funding deficiency and such accumulated funding deficiency is not corrected within the correction period, there is hereby imposed a tax equal to 100 percent of such accumulated funding deficiency to the extent not corrected. The tax imposed by this

subsection shall be paid by the employer described in subsection (a).

26 U.S.C. § 4971(a) & (b). The quoted statute was in effect when the events leading to this litigation transpired. In 1987, Congress amended Section 4971(a) to delete the "5 percent" assessment and substitute "10 percent (5 percent in the case of a multiemployer plan)" in its place. Pub. L. 100-203, Title IX, § 9304(c)(1), 101 Stat. 1330-348.